The Economist
June 25th, 2011

Politics this week

It was a turbulent week for **Greece** and the euro zone. As angry demonstrators filled the squares of Athens, George Papandreou, the prime minister, narrowly won a vote of confidence in parliament. A bigger test will come when Greek politicians vote on contentious legislation to enact yet more austerity measures and structural reforms. Euro-zone finance ministers meeting in Luxembourg gave warning that the next tranche of bail-out funding for Greece, which is needed to avoid a debt default in mid-July, would be released only if the legislation is passed. See article

The IMF said that contagion from the Greek crisis posed considerable risks to the **Spanish economy** and that efforts on reform must not slow. Earlier, up to 200,000 people rallied on the streets of Spanish cities, protesting against austerity and political corruption. The so-called *indignados* plan to stage a huge demonstration in Madrid in late July.

Silvio Berlusconi, **Italy's** prime minister, promised both to lower income taxes and to keep the budget deficit under control, after he won a vote of confidence in parliament. Days earlier Umberto Bossi, the leader of the Northern League, Mr Berlusconi's coalition partner, had called for tax cuts. See article

A court in the **Netherlands** cleared Geert Wilders on all charges of inciting hatred against Muslims. Mr Wilders, who leads a far-right party that supports the minority government, has compared the Koran to "Mein Kampf". His trial was seen as a test of Dutch freedom-of-speech laws.

Going against the traffick

The presidents of seven Central American countries, Colombia and Mexico, together with Hillary Clinton and other foreign ministers, gathered in Guatemala for a summit which approved a co-ordinated strategy against drug mafias in **Central America**. See article

After having kept **Argentina** guessing for months, Cristina Fernandez de Kirchner, the president, said she would seek a second term at an election due in October. Opinion polls suggest that she should win easily against a splintered opposition.

In **Venezuela** troops laid siege to a prison after 22 people were killed in battles between rival gangs of inmates.

Haiti's parliament rejected Michel Martelly's nominee for prime minister, a setback for the country's new president.

A bloody regime

In his first public speech for two months, Bashar Assad, **Syria's** embattled president, called for a "national dialogue", once again promised reform, and said an election would be held in August-but with no hint that his ruling Baath party would allow an opposition to compete. Demonstrations and killings continued. See article

Tunisia's former president, Zine el-Abidine Ben Ali, and his wife were each sentenced in absentia to 35 years for corruption and fined $66m.

As **Yemen's** government in Sana'a seemed to lose its grip, dozens of members of al-Qaeda escaped from a prison in the southern port city of Mukalla. Allies of the organisation have recently captured or attacked several towns in the region.

In **Bahrain** eight pro-democracy campaigners, all Shias, were given life sentences in a special security court for "plotting to overthrow the government". Thirteen other opposition figures were sentenced to up to 15 years in prison, seven in absentia.

A spate of bombings in **Iraq** killed at least 35 people, 27 of them in Diwaniya, south of Baghdad, the capital. The attacks were presumed to have been carried out by Sunni extremists linked to al-Qaeda.

In a blow to **Palestinian** hopes of unity, Mahmoud Abbas and Khaled Meshal, leaders respectively of Fatah and Hamas, the two main Palestinian factions, who have agreed to oversee jointly a government of technocrats, cancelled a meeting at which they were meant to select a prime minister.

Nice to see you

China released **Ai Weiwei** on bail from detention, after the artist and human-rights activist admitted evading tax. Mr Ai was arrested in April as he boarded a flight for Hong Kong, and was held in secret without access to a lawyer. China said it released Mr Ai for "his good attitude in confessing his crimes" and because of a chronic illness. See article

After government-backed protests in Hanoi demanded that **China** respect **Vietnam's** territorial claims in the South China Sea, the two countries conducted a joint naval patrol in disputed waters. China urged America to avoid getting involved in the dispute.

A volcano in Chile continued to send plumes of ash across the **southern Pacific**, obscuring airspace in the far south of the world and grounding flights around the region.

Pakistan arrested Brigadier Ali Khan for his ties to Hizb-ut-Tahrir, a banned Islamist group. The most senior Pakistani army officer to be taken into custody in a decade, Brigadier Khan was detained shortly before India's foreign secretary flew to Islamabad for talks with her Pakistani counterpart. Both sides started a dialogue in February for the first time since the Mumbai attacks of 2008, in which Pakistani officers are accused of involvement.

The beginning of the end

Barack Obama proposed withdrawing 33,000 troops from **Afghanistan** by the end of next summer, with 68,000 remaining to support the transition of responsibility for security to the Afghans by 2014. Some military men worried that Mr Obama's plan would hamper American advances against the Taliban. See article

Republicans threatened to stop funding American participation in the Libya campaign, claiming that Mr Obama is violating the 1973 **War Powers Resolution** by not seeking congressional approval for military action. Senators John Kerry and John McCain introduced a bipartisan resolution authorising the president to commit forces, but not to deploy ground troops. See article

Jon Huntsman declared his candidacy for president. The former governor of Utah and ambassador to China is a late entry to the Republican field, but is exciting interest as a more charismatic version of Mitt Romney, the party front-runner. As an Obama appointee to China, however, he is sure to get a rough ride from conservative activists.

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Business this week

In an important test of the law on class-action lawsuits in America, the Supreme Court threw out a case that had been brought on behalf of 1.5m female workers at **Walmart**. The case claimed that women were discriminated against in pay and promotion, but the court ruled that the plaintiffs could not show a common grievance. The employees may still pursue their claims in smaller groups or individually. Business groups had predicted a flood of sex-discrimination lawsuits if the court had let the class-action suit stand. See article

Women activists interrupted **Carrefour's** shareholder meeting in Paris, to protest that there are too few female executives at the world's second-largest retailer. At the meeting shareholders backed a plan to spin off Dia, Carrefour's low-cost supermarket chain. It was also confirmed that Lars Olofsson would become chairman in addition to his job as chief executive, as the company rejigs its European operations.

Enough already

As expected, the **Federal Reserve** announced no new initiatives at its regular policy meeting, marking the end of its second programme of quantitative easing. But with the Fed again lowering its growth forecast for the year, interest rates will stay pinned to the floor. Ben Bernanke, its chairman, said he would be "prepared to take additional action if conditions warranted".

PNC Financial Services bought the American retail-banking business of **Royal Bank of Canada** for $3.45 billion. It was the second big banking deal within a week: **Capital One Financial** acquired the American online-banking unit of **ING**, a Dutch company, for $9 billion.

JPMorgan Chase agreed to pay $154m to settle a civil-fraud charge that it misled investors about a mortgage-securities portfolio by failing to disclose that a hedge fund, which had helped to select the assets for the portfolio, was at the same time betting that half of the assets would lose money. JPMorgan neither admitted nor denied wrongdoing.

Winifred Jiau was found guilty of securities fraud in the first insider-trading-related trial of someone who works at an **expert-network** company, a business where clients in finance are hooked up with specialists in a given industry.

Timber!

Paulson & Co, a hedge fund, was estimated to have lost $500m when it sold its stake in **Sino-Forest**, a forestry company that has been accused by a short-seller of overstating its assets in China, causing its share price to collapse.

After an internal inquiry into last year's explosion on the Deepwater Horizon rig in the Gulf of Mexico, **Transocean**, the owner of the rig, placed the blame for the disaster firmly on **BP**, the rig's operator. The presidential commission that investigated the incident concluded that BP and its contractors should share the blame. That finding has been accepted by other contractors, inducing them to settle with BP, including, this week, the firm that made the well's float collar.

Citigroup began the process of putting **EMI** up for sale (the music company said it was seeking "strategic alternatives"). In February Citi seized EMI from Terra Firma Capital Partners as the private-equity firm struggled with loans that it had obtained from the bank to finance its buy-out of EMI. One potential bidder for the business could be Len Blavatnik, who recently bought Warner Music.

Foster's rejected a takeover bid from **SABMiller**, which valued the Australian beer company at A$9.5 billion ($10.1 billion). Foster's recently divested its sagging wine business to refocus solely on its "amber nectar". Other big brewers are expected to submit rival offers to SABMiller's.

Qantas reached a settlement with **Rolls-Royce** for last November's explosion in a Rolls-Royce Trent 900 engine on one of its jets, which forced an emergency landing and caused the airline to ground aircraft as it conducted safety tests. Qantas will note the value of the settlement as A$95m ($101m) in its earnings.

Research in Motion's share price fell by 21% after the BlackBerry-maker lowered its outlook for the year. Once considered to be the hottest wireless device around, the BlackBerry has not gained much from the growing demand for smartphones; its share of the market in North America has shrunk to 17% from around 50% just two years ago.

It's a rich man's world

An annual survey estimated that the combined **wealth** of the world's 10.9m rich people (27% of whom are women) stood at $42.7 trillion in 2010, more than in 2007, the year the financial crisis was brewing. More than half of the monied classes live in the United States, Japan and Germany, though Asia has more in total than Europe for the first time.

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The euro crisis

If Greece goes…

The opportunity for Europe's leaders to avoid disaster is shrinking fast

THE European Union seems to have adopted a new rule: if a plan is not working, stick to it. Despite the thousands protesting in Athens, despite the judders in the markets, Europe's leaders have a neat timetable to solve the euro zone's problems. Next week Greece is likely to pass a new austerity package. It will then get the next euro12 billion ($17 billion) of its first euro110 billion bail-out, which it needs by mid-July. Assuming the Europeans agree on a face-saving "voluntary" participation by private creditors to please the Germans, a second bail-out of some euro100 billion will follow. This will keep the country afloat through 2013, when a permanent euro-zone bail-out fund, the European Stability Mechanism (ESM), will take effect. The euro will be saved and the world will applaud.

Time to stop kicking the can

That is the hope that the EU's leaders, gathering in Brussels as *The Economist* went to press, want to cling to. But their strategy of denial-refusing to accept that Greece cannot pay its debts-has become untenable, for three reasons.

First, the politics blocking a resolution of the euro crisis is becoming ever more toxic (see article). Greeks see no relief at the end of their agonies. People are protesting daily in Syntagma Square against austerity. The government scraped through a vote of confidence this week; the main opposition party has committed itself to voting against the austerity plan next week and a few members of the ruling Socialist party are also doubtful about it. Meanwhile, German voters are aghast at the prospect of a second Greek bail-out, which they think would merely tip more money down the plughole of a country that is incapable either of repaying its debts or of reforming itself. As the climate gets more poisonous and elections approach in France, Germany and Greece itself, the risk of a disastrous accident-anything from a disorderly default to a currency break-up-is growing.

Second, the markets are convinced that muddling through cannot work. Spreads on Greek bonds over German bunds are eight points wider than a year ago. Traders know that Greece, whose debts are equivalent to around 160% of its GDP, is insolvent. Private investors are shying away from a place where default and devaluation seem imminent, giving the economy little chance of growing. The longer restructuring is put off, the more Greek debt will be owed to official lenders, whether other EU governments or the IMF-so the more taxpayers will eventually suffer.

The third objection to denial is that fears of contagion are growing, not receding. Early hopes that Greece alone might need a bail-out were dashed when Ireland and Portugal also sought help. The euro zone has tried to draw a line around these three relatively small economies. But the jitters of recent weeks have pushed Spain and even Italy back into the markets' sights again. The belief that big euro-zone countries could be protected from attack has been disproved. Indeed, far from fears of contagion ebbing, the talk is of a Greek default as a "Lehman moment": like the investment bank's bankruptcy in September 2008, it might unexpectedly bring down many others and devastate the world economy.

While the EU's leaders are trying to deny the need for default, a rising chorus is taking the opposite line. Greece should embrace default, walk away from its debts, abandon the euro and bring back the drachma (in a similar way to Britain leaving the gold standard in 1931 or Argentina dumping its currency board in 2001).

That option would be ruinous, both for Greece and for the EU. Even if capital controls were brought in, some Greek banks would go bust. The new drachma would plummet, making Greece's debt burden even more onerous. Inflation would take off as import prices shot up and Greece had to print money to finance its deficit. The benefit from a weaker currency would be small: Greece's exports make up a small slice of GDP. The country would still need external finance, but who would lend to it? And the contagion risk would be bigger than from restructuring alone: if Greece left, why not Portugal or even Spain and Italy? If the euro zone were to break up it would put huge pressure on the single market.

The third way

There is an alternative, for which this newspaper has long argued: an orderly restructuring of Greece's debts, halving their value to around 80% of GDP. It would hardly be a shock to the markets, which have long expected a default (an important difference from Lehman). The banks that still hold a big chunk of the bonds are in better shape to absorb losses today than they were last year. Even if Greece's debts were cut in half, the net loss would still represent an absorbable proportion of most European banks' capital.

An orderly restructuring would be risky. Doing it now would crystallise losses for banks and taxpayers across Europe. Nor would it, by itself, right Greece. The country's economy is in deep recession and it is running a primary budget deficit (ie, before interest payments). Even if Greece restructures its debt and embraces the reforms demanded by the EU and IMF, it will need outside support for some years. That is bound to bring more fiscal-policy control from Brussels, turning the euro zone into a more politically integrated club. Even if that need not mean a superstate with its own finance ministry, the EU's leaders have not started to explain the likely ramifications of all this to voters. But at least Greece and the markets would have a plan with a chance of working.

No matter what fictions they concoct this week, the euro zone's leaders will sooner or later face a choice between three options: massive transfers to Greece that would infuriate other Europeans; a disorderly default that destabilises markets and threatens the European project; or an orderly debt restructuring. This last option would entail a long period of external support for Greece, greater political union and a debate about the institutions Europe would then need. But it is the best way out for Greece and the euro. That option will not be available for much longer. Europe's leaders must grab it while they can.

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China's future

Rising power, anxious state

Tensions between China's prosperous middle classes and its poor will make it a harder country to govern

AMONG those with most to celebrate as the Chinese Communist Party marks its 90th birthday on July 1st are the country's bourgeois reactionaries. Perhaps now the most important pillar of the party's support, China's middle class was virtually non-existent until it was recreated in the late 1990s. So far, the communists have amply fulfilled their side of a tacit bargain in which well-off city-dwellers have traded political choice for fast-growing prosperity. But as the economy slows over the next decade, the party will struggle to keep its word. Indeed, peace and prosperity may depend on the very sort of political reform the party has tried so hard to avoid.

An affair to remember

In the past 15 years the middle classes have supported the party because of what it has done for them. Its rule has produced incredible economic progress, asserted China's rightful role as a global power and, crucially, kept the country from falling back into the chaos that plagued it during so much of the 20th century. The post-Communist travails of the former Soviet Union have been valuable as what the party used to call "teaching by negative example".

However, the love affair between a party that calls itself the vanguard of the proletariat and its actual, middle-class supporters is now under threat. At the root of this is an inevitable slowing in economic growth. As our special report on China in this issue explains, the first decade of the century, with its relentless double-digit growth, may well have seen the peak of China's economic exuberance. A sudden crash is not impossible: there could be a botched attempt to tackle either the property bubble or what the prime minister calls the "uncaged tiger" of inflation (now at 5.5%, its highest level in nearly three years). But an immediate upset is still unlikely: inflation is not yet out of control, still far below the 27.7% it reached in 1994. The danger is more in the medium term: growth will inevitably slow over the next decade, as China settles into its status as a middle-income country, and the burden of caring for an ever larger number of elderly people in a slower economy may make middle-class life far more uncomfortable.

To compensate, the party will have to usher in wrenching change. It is struggling to shift China away from the current unsustainable model, where growth is propelled by vast investment and export-led manufacturing, towards one where domestic consumption plays a bigger role. The country still has a long journey ahead in its efforts to build health-care, pension and social-security systems to reassure citizens: all of these are necessary to persuade the middle class to save less.

In addition, China's state-owned businesses have an insatiable appetite for capital, which many of them waste. Curbing state companies means taking on all of the well-connected people who ride on their coat-tails, including parts of the middle class. The party's creed ("Marxism-Leninism-Mao Zedong thought") means nothing to most such people. The party is secretive about recruitment to its 80m-strong ranks. But an official report in 2008 said that, of new applicants for membership, by far the biggest category comprised university students over the age of 18. Although the decision by these young careerists to sign up shows the party's clout, they have very different ambitions from those of the old ideologues.

The party will also have to work harder to sustain the urbanisation that has fuelled the economy. China has done the easy part: attracting underemployed young rural residents to urban jobs. But the supply is beginning to slow. It would help if farmers could sell or mortgage their rural land and use the money to help gain a stronger foothold in the cities. But the party remains overly fearful of privatising farmland, partly for atavistic fears of a destitute peasantry, and partly for ideological reasons.

Worse still, the system of household registration, or *hukou*, defines even long-staying urban migrants as rural residents, cutting them out of housing, education and other benefits. No wonder that the migrants are increasingly restive. Of the tens of thousands of protests each year, most are still rural, typically by farmers enraged by inadequate compensation for land appropriated for development. However, urban unrest, such as recent riots by factory workers in the southern province of Guangdong, is now more common. If the party is to keep the peace in cities and if it is to continue to attract migrants in sufficient numbers, it needs to find ways to turn them into full-fledged city-dwellers, with the consumer power to match.

Of taxation and representation

Here it runs up against the middle class most directly. To give migrants the same housing and other benefits as urban *hukou* holders, and to build a proper social safety-net will be expensive. And if more tax is the solution, then the middle class could well begin demanding a greater political say.

That is a day the party dreads. Since the nationwide student-led protests of 1989, the educated urban elite has mostly been politically quiescent. But the party fears them far more than it does unruly farmers or migrants. Beijing's centre was flooded with police earlier this year when calls for an Arab-style "jasmine revolution" circulated on the internet.

The middle class's anxieties have not yet fermented into a broader anti-government rage. But then the inevitable erosion of some of their privileges has barely begun. If the bourgeoisie does start to protest, the party will be faced with an old dilemma: liberalise or step up repression. All the evidence of the past-and of the recent crackdown-is that it will choose repression. But that in itself may help politicise the middle class. In other Asian countries a taste for democracy has risen with income; and repression would mean withdrawing freedoms from people used to their liberty gradually increasing.

In 2012 the party's leadership-and the task of managing these tensions-is to pass to a new generation. The most recent leadership transition, in 2002, went smoothly. But every previous generational shift in the party's 90 years has been chaotic, and, a decade on, the tasks faced by the leaders who took over in 2002 look almost easy by comparison with today's.

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Barack Obama and Afghanistan

A gamble that may not pay off

The president is at risk of running down American forces in Afghanistan too fast

THE real question facing Barack Obama over Afghanistan is just what the United States is trying to achieve there. Plenty of Americans, weary of war and anxious about their own plight at home, think that the death of Osama bin Laden should have marked an end to the mission that took 100,000 troops to a distant and dismal part of the world. Afghanistan will cost America roughly $120 billion this year. Many Americans want this money to go towards creating jobs in Kansas rather than in Kabul.

By announcing on June 22nd that he would withdraw 10,000 troops this year, and the remaining 23,000 members of the "surge" by the end of the summer of 2012, Mr Obama tried to give everyone something. To his political strategists, worried about re-election, his message was that nation-building should start at home. To his generals, worried by any withdrawal, he can still claim that he will end his first term with many more troops in Afghanistan than were there when he began it. The middle ground is often good politics; it is less comfortable in warfare. In this case, history will probably judge that Mr Obama took out too many soldiers too early.

Talibanishment

Afghanistan's future turns on whether the central government appears stable, or whether it looks as if it will collapse as soon as NATO troops retreat from the field of battle. The more permanent the government, the more likely rival tribes, ethnic groups and factions will be to seek to negotiate their place in the pecking order, rather than fight for supremacy in a civil war. Crucially, that includes the Taliban.

It is true that Afghanistan looks like a failure beside the dream of 2001, when NATO invaded. It will continue to be plagued by violence and insurgency. Even with the best outcome there, women will suffer discrimination, poppies will flourish and corruption will eat away at daily life. But any hope of a decent life there depends on peace. Avoiding a full-blown civil war is crucial for Afghans.

The outside world also has a stake in its (relative) stability. A vacuum in Afghanistan threatens the entire region. Nuclear-armed India and Pakistan, an incendiary couple, risk a proxy war through the different ethnic groups they sponsor in the country. Iran, China and Russia could all be sucked in. And a lawless Afghanistan could again become al-Qaeda's base.

In his speech this week, Mr Obama seemed too prepared to run the risk of all this happening. For the time being he is offering some help to protect the government; but the momentum of the surge will ebb. He is willing to stay long enough to train the Afghan army and police needed to protect the government. But after 2014, when that job is supposed to be complete, will he (or his successor) be willing to pay for the Afghan army and to keep some foreign troops there as a deterrent to civil war? Such doubts will make Afghans less likely to reckon on the government enduring-and hence more likely to fight it.

The pity of this is that, with help, there is every chance that government in Kabul could survive-preferably under some other leader than the erratic Hamid Karzai. After all, Mohammad Najibullah, unloved, isolated and opposed by a superpower, lasted for more than three years after being ditched by the near-bankrupt Soviet Union in 1989. Mr Obama's decision this week does not condemn the mission to failure. But it does make it harder to realise than it need have been.

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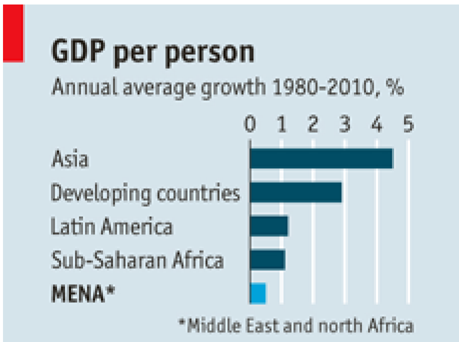
The economics of the Arab spring

Open for business?

Economic reform in the Middle East could prove harder than in eastern Europe. The West needs to help it along



IS THE Arab spring a 1989 moment? The collapse of communism remade eastern Europe both politically and economically, as vibrant market economies emerged from the rubble of central planning. Optimists argue that democratic transitions in the Middle East and north Africa could transform the region's lousy economies (see chart). Countries such as Egypt and Tunisia don't have to build a capitalist system from scratch. But their state-dominated economies need an overhaul, similar in nature-if not in scale-to that in eastern Europe. Unfortunately, though the task is smaller, there are several reasons why it could be a lot harder.

Unlike eastern Europe, all Arab countries (those with oil wealth and those without) have capitalist economies, in which prices and private enterprise play a big role. Yet it is a distorted, patriarchal capitalism, characterised by a dominant state, kleptocratic monopolies, heavy regulation and massive subsidies. This has fuelled corruption, stunted growth and left millions without jobs. High oil prices give petro-economies the wherewithal to counter discontent by dispensing largesse. Those without such wealth face a growing fiscal mess.

Take Egypt. Outside agriculture, over 40% of the economy is in state hands, with a hefty chunk controlled by the army. Private firms are strangled with red tape. Subsidies for food and fuel, worth some 10% of GDP, are busting the budget. The result is that Egypt faces a fiscal crunch as well as an urgent need to overhaul its economic model (see article).

Top of the to-do list is reform of subsidies, so that government handouts are confined to the needy. Next comes a set of measures needed to foster private enterprise: breaking up monopolies, reducing the size of the state and rewriting regulations so that they support rather than suffocate competition. That sounds like a slimmed-down version of the post-communist transition agenda, where privatisation and the creation of competitive markets were also priorities. Unfortunately, the Middle East faces two big problems that eastern Europe didn't.

First, eastern Europe's transition had a clear aim: membership of the European Union. For all the EU's current difficulties, it provided both a powerful political motivator and a detailed reform blueprint. The economies of the Middle East and north Africa have no such lodestar. Joining the EU is not an option. And although European politicians talk of deeper

partnerships with the awakened countries, they still refuse to cut the trade barriers that matter, such as those on farm exports.

Second, the appetite for reform is far feebler. East Europeans wanted economic freedom along with democracy. In the Middle East popular anger at corruption and high joblessness have not translated into demands for wholesale economic reform. Quite the contrary. In Egypt the transitional government has expanded subsidies and increased employment in state firms. Economic liberalisation has a poor reputation, thanks to reforms earlier this decade whose fruits flowed largely to the well-connected. Indeed, a desire for vengeance against fat cats helped to bring the crowds onto Tahrir Square.

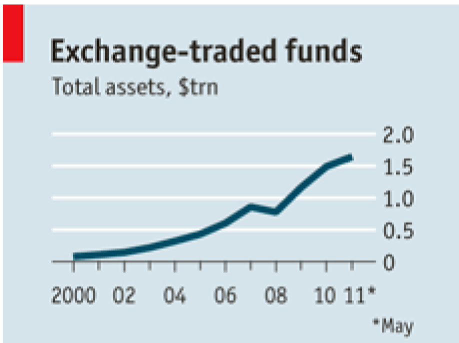
Fortune and favours for the bold

So the Middle East's economic transition could be a lot bumpier than that of eastern Europe (which was itself a pretty rough ride at times). The West's strategy for assistance must change accordingly. Up to now the focus has been on financial help: America has offered debt relief to Egypt, the IMF has lent cash with few strings attached. That buys time but does not promote reform. In future, aid should become more conditional, aimed at helping private enterprise. And far more important than cash will be the West's willingness to offer freer trade and real integration to the successful reformers and democratisers. Maybe not EU membership, but something close.

Exchange-traded funds

A good idea in danger of going bad

The reckless expansion of "synthetic" funds requires a few new rules



IN FINANCE, the simple ideas are often the best. Exchange-traded funds, first launched 21 years ago, were a great idea. They were in effect tradable mutual funds. An investor got exposure to a diversified portfolio of shares, like the S&P 500 index, at low cost. And he could sell it easily, like any other equity.

But the popularity of such funds, which now have $1.5 trillion of assets under management, was too great a temptation. When the public took to plain-vanilla ETFs, the financial services industry decided it should also offer egg-custard and blue-banana flavours. Investors can choose between more than 2,700 funds covering everything from Asian property to water companies. They can also buy leveraged funds, which rise and fall more rapidly than the assets they track, and "inverse ETFs", which move in the opposite direction.

In theory, this gives investors all the tools they need to design the portfolio which closely matches their risk preferences and economic outlook. In practice, however, such diversification has thrown up a number of risks (see article).

Not what it says on the tin

One risk relates to liquidity. In some sectors, like emerging markets, it is easier for investors to buy and sell an ETF than to trade in the underlying illiquid assets. But the liquidity risk has not gone away. Although shares in the funds may be easily sold, the assets behind them are not; and when all the bidding is one way, dealers may be unwilling to make a market. During the market turmoil known as the "flash crash" in May 2010, the Dow Jones Industrial Average briefly dropped 1,000 points as liquidity evaporated; 60-70% of the trades that subsequently had to be cancelled were in ETFs.

Another risk concerns a change in the nature of ETFs. The early funds tended to replicate an index: buying every share in the FTSE 100, for example. But as the industry expanded into illiquid asset categories, that strategy was no longer practical. The answer was the development of "synthetic ETFs" and related products such as exchange-traded notes (ETNs). These funds do not own assets like shares or bonds; instead they arrange a derivative deal with an investment bank, which guarantees to deliver the return of the targeted benchmark.

This exposes the ETF investor to the risk that the bank fails to pay up. To offset the risk, the bank has to hand over collateral. Those assets are subject to some controls, but do not have to be related to the aim of the ETF. The international Financial Stability Board found that the collateral pledged to one emerging-markets fund largely comprised Japanese shares and American bonds. If the bank failed, ETF investors would find that they acquired a hotch-potch of assets, rather than the portfolio they expected. Worse still, investment banks may have an incentive to establish ETNs and synthetic ETFs as a cheap way of financing their assets. It all sounds suspiciously like the subprime mortgage boom, when banks parked illiquid assets in off-balance-sheet vehicles. The problem is not on the same scale: synthetic ETFs and ETNs are a small proportion of the industry. But the subprime market also started small.

What should be done? The greatest need is for transparency: it should be made as clear as possible to investors what they are buying. They ought to be able to tell the difference between a normal and a synthetic ETF just by looking at the fund's name. The exact nature of the collateral should be disclosed on a regular basis, like the main investments in a mutual fund's portfolio. Investors ought to be told that the market for ETFs may not always be as liquid as they would like. And the industry should look to its own self-interest: it would be a shame if reckless expansion spoiled a good innovation.

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Letters

On the Carnegie Corporation,tiny nations, crime rates, Japan, nuclear power, Weinergate

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Letters are welcome via e-mail to letters@economist.com

The Carnegie Corporation

SIR - I found it disturbing that there was no one quoted and no research cited in your article on IBM versus the Carnegie Corporation ("The centenarians square up", June 11th). Therefore, it appears to us that the conclusions reached in the article were predetermined. To say that Carnegie has "stayed the same during the past 50 years" is either to ignore or to dismiss our landmark 1990s research on childhood education, which influenced state and national education policies. Indeed, our investment in school reform continues to influence the way states and cities are redesigning their school systems.

How can we have "stayed the same" when we initiated the partnership of seven foundations that invested $440m in advancing higher education in Africa and helped to revitalise some of the most prominent universities there. We have also invested in 127 Carnegie scholars who have expanded the research that is essential to understanding the complexities of Muslim societies. In addition, Corporation support for the Library of Alexandria will result in 200 volumes on secularism and Islam being published. You also did not mention our decades-long commitment to international peace and to nuclear non-proliferation that continues to resound in the work of organisations such as the Nuclear Threat Initiative and the International Institute for Strategic Studies.

Foundations are not about money alone. They are also about ideas. In that regard, innovation, commitment and ideas still dominate the Carnegie Corporation's culture and I believe Andrew Carnegie would be proud of what he'd find 100 years after he challenged us to "Do real and permanent good in this world", not only today, but into the future.

Susan King
Vice-president, External affairs
Carnegie Corporation of New York

SIR - As the author of a biography of Andrew Carnegie and of several articles on philanthropy, I take issue with your comparison of the Carnegie Corporation and IBM at the time of their 100th anniversary. You were right to say that "at first glance, IBM and the Carnegie Corporation seem to be engaged in such different endeavours that comparing them might seem about as sensible as comparing apple orchards and orange groves." If only you had stopped at this "first glance" instead of proceeding to a meaningless comparison.

Carnegie has manufactured no mainframes or personal computers in its 100 years. It makes no sense to contrast a company, the "main aim" of which is to make money for its shareholders, with a philanthropic corporation which, as you say, "explicitly set out to create a better world".

Andrew Carnegie attempted to add a dimension of moral accountability to American capitalism. In his exhortations to give back to communities, he imposed on America's millionaires an obligation that, slowly but inevitably, they are beginning to accept in the 21st century. To tell them now that the world would be better off if they kept on making money for themselves and their shareholders, instead of putting some of their wealth into charitable foundations, is not only unfounded but borders on the ludicrous.

David Nasaw
Professor of history
City University of New York
Graduate Centre

Citizens of tiny islands

* SIR - The implications of your article on tiny and submerging island states are a stretch ("I am a rock. I am an island", May 28th). Some small islands with the equivalent population of little market towns are now to be considered as "nations", surviving only with the charity of former colonial masters.

Apparently they need have no real basis in fact, apart from being a tax haven, flying a flag of convenience and issuing a postage stamp. According to you, they need not exist on physical land either.

Your reference to Atlantis was apt. We are lucky it is a myth, otherwise a DNA link could identify hordes of Atlantis's descendants and the oil- wells and fisheries of the Atlantic basin would be fair game for their claims. Just add lawyers and a bank account so we know where to send the money.

John Woods Conlin
Chadds Ford, Pennsylvania

Crime and security

SIR - Another factor behind falling crime rates ("Good news is no news", June 4th) is the possibility that crime is driven by the volume of available criminal opportunities. Specifically, crime has declined as security has improved in recent years. A study by our research team links the abatement of car theft to the spread of better security, such as immobilisers and central locking. In Britain joyriding has been largely eliminated and professional car theft for resale has fallen sharply.

The relationship between the long-term fall in violent and property crimes is not yet fully understood. Stolen cars certainly facilitate other crimes. They are used for transporting stolen goods, searching for residential and business crime targets, driving to drug markets, as getaway vehicles and in drive-by shootings. Preventing car theft may have precipitated a reduction in other crimes. Car theft used to be an easy crime that young offenders learned early on, so removing that rung may halt their move up the criminal ladder.

Household security has also improved significantly. And in retailing an array of technology has emerged to secure, tag and other otherwise reduce the theft of valuable goods. Shipments are tagged and monitored in the supply chain. Portable phones may provide better personal protection than we realise: neighbours are more easily called to assist, or potential assailants deterred by the threat of passers-by with digital cameras. One colleague is exploring the notion that the routine activities of potential teenage offenders have been disrupted by computer games, which keep them indoors.

The policy implications are clear. Crime is an area in which market failure occurs. As it does for food, fire and children's toys, government should promote a mix of regulation and incentives to encourage manufacturers, designers and urban planners to consider safety as the default in their blueprints.

Graham Farrell
Professor of criminology
Loughborough University
Loughborough, Leicestershire

* SIR - You went as far to suggest that the mere presence of Barack Obama in the White House may be an explanation for the drop in crime rates over the past two years. Another theory could be that second-amendment rights to carry concealed weapons for self-defence have been greatly expanded, thus giving criminals pause.

Mike Caliendo
Muskegon, Michigan

* SIR - Another factor that almost certainly has played a part in America's falling crime rate is military service. Since 2001, military recruitment has increase substantially and entry requirements have dropped. This has taken many young men off the streets and given education, training and discipline to all recruits.

Doug Clark
Shanghai

Leave politics aside, for now

SIR - I agree that to let Japan's Liberal Democratic Party back into power would be a terrible idea ("A grand stitch-up or an election?", June 11th). However, you too easily brushed aside the logistical difficulty of organising an election in the north-east of Japan at the moment. Moreover, an election now would not leave enough time for new or alternative candidates to enter the fray.

Both the LDP and the Democratic Party of Japan have insisted that a grand coalition now would be temporary, with a clear expiry date attached to be followed by an election. That would be the least bad option in the present situation. Unity in Parliament is necessary for, say, the next six to nine months to pass funding and other requisite bills for reconstruction.

Unfortunately, with the customary pitiful mindset of the political class, only a grand coalition can achieve that. Once the situation on the ground has improved however, let the people of Japan choose a more open-minded and younger generation of leaders to push aside the current bunch.

Antoine Roth
Tokyo

An irrational response to Fukushima

* SIR - Regarding Germany's decision to reduce nuclear power output, I can only say that we have all gone collectively insane in Europe ("Nuclear? Nein, danke", June 4th). There were only a few deaths resulting from the Fukushima nuclear incident in Japan and about a dozen people were treated for minor burns and released from hospital. Deaths from the latest *E. coli* outbreak in Germany, blamed on organic bean sprouts, number at least 35; more than 3,000 people have been taken ill with different levels of exposure to the bacteria.

What now Chancellor Merkel? Is Germany going to phase out unsafe and evil organic farming? Uncharacteristically, it is the French who are showing remarkable common sense so far and will likely reap the rewards through their nuclear-power industry in the form of increased demand from both Germany and Italy.

Jesus de Ramon-Laca
London

Weinergate

SIR - Now that Anthony Weiner has stepped down as a congressman after parading in his underpants on Twitter, could I make a plea for all politicians to permanently disable their social-networking accounts to save us all from further embarrassments ("The Weiner war", June 11th). As well as Mr Weiner there was another congressman not so long ago who also sent out images of his manly pecs, and I seem to remember a British MP was caught in the buff once on a dating site. This has got to stop. How long before we get to see John Boehner in his boxers, or (perish the thought) Eric Pickles in his briefs?

Stephen Evans
Manchester

* Letter appears online only

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Greece and the euro

The brewing storm

George Papandreou's new government has passed its first pressing test. But disaster may still loom

IN THE middle of Syntagma Square in central Athens, flanked on one side by parliament and on another by luxury hotels, would-be revolutionaries jostle for space with phlegmatic African street-traders selling handbags. On June 22nd one group of youngsters conducted a spontaneous "economics lesson" in which terms such as "credit event" and "haircut" were explained and deconstructed. Petrograd 1917, or even Paris 1968, it was not.

Nonetheless, the stakes are very high. It is entirely possible that in the weeks to come the situation in Athens could go from being strained, angry and confused to plain catastrophic: negotiations between Greece's economic rescuers and its political leaders may fail, and the state may run out of money and/or crash out of the euro, triggering a financial crisis that would reverberate round the world.

Even if that were avoided, Greece's fundamental problems would hardly improve. For the country is not just bust, it is deeply uncompetitive, and dealing with that will require years of painful reforms.

But those gritty realities seem to have escaped most of the actors in the drama which is unfolding inside and outside the Greek parliament. In time-honoured fashion, the country's political parties are jockeying for advantage, with little regard for the disaster that they might help to bring about. Meanwhile, the demonstrators outside are chanting slogans implying that the happy days of living well on borrowed money can come back if they only shout loud enough, and if the "traitors" and "thieves" who spoiled the party are given their just deserts.

In the short term, the Socialist government has gained some breathing space in its struggle to endure the twin pressures of popular discontent (over the austerity already imposed) and international demands for reform. The ruling party's fractious legislators, galvanised by fears they might lose power, rallied behind George Papandreou, the prime minister, in the early hours of June 22nd to give his new cabinet a vote of confidence. All 155 Socialists turned out for the roll-call vote, which went strictly along party lines.

Minutes before the vote the opposition walked out because of a noisy, petty argument over whether "democracy" had returned to Greece in 1974, when the military dictatorship fell, or in 1981 when the first left-of-centre administration was elected. Mr Papandreou managed to coax his opponents back by pointing out what an appalling impression such squabbles make on the rest of the world at such a grave hour in the country's history.

New Democracy, the centre-right opposition party, is withholding support for an internationally agreed austerity and privatisation plan on the ground that it can and should be renegotiated, with more emphasis on tax cuts. Few people outside Greece see much scope for that. But some of the government's critics, especially on the left, gleefully observed that Greece's international partners seemed to soften their stance slightly around June 15th, when street protests came to a head and the country looked ungovernable.

This week's small successes for the government left the anti-austerity protesters outside parliament unimpressed. They said they were issuing their own vote of no confidence in the country's entire political class. Admittedly, their four-week-old tent village (modelled on the Spanish version) looks scruffier by the day. But the protesters say they will stick it out at least until the next critical vote, on a five-year austerity package intended to prevent a default and put the country on the road to recovery. They are planning a "day of action" as the vote takes place.

Regardless of the atmosphere on the streets, there are big question-marks over Greece's future. The current euro110 billion ($159 billion) bail-out package from its European partners and the International Monetary Fund will not be enough. Mr Papandreou is betting that the EU and the IMF will come up with another euro100 billion (or so) to keep the country going until well into 2014, when, perhaps, it can move seamlessly into the EU's new stability mechanism for propping up fiscal miscreants.

The vote reassured anxious European bureaucrats who have been relying on Mr Papandreou to impose fiscal discipline, setting aside his "soft" Socialist credentials. The prime minister had already won a standing ovation from his Panhellenic Socialist Movement's (Pasok's) parliamentary group after reneging on an earlier suggestion that he might make way for a non-political premier-Lucas Papademos, a respected former deputy president of the European Central Bank-and a group of technocrats to handle the next crucial round of reform.

Some of Mr Papandreou's party faithful were riled by the fact that he mooted the idea of a national-unity government at a meeting with Antonis Samaras, the leader of New Democracy, before he had cleared it with his Socialist colleagues. Aides to Mr Papandreou say his proposal to Mr Samaras, made in the highest interests of the country, was torpedoed within

hours when New Democracy leaked the content of their discussion to the press. So it was clear enough who had acted in a statesmanlike way, and who was playing small-time politics.

Tough men to the fore

The prime minister moved quickly to shore up his own position within the party by promoting some old Socialist warhorses and dispensing with some young proteges who were seen as personal friends. Out went Tina Birbili, the environment and energy minister, who opposed privatisation of the state electricity company, and Dimitris Droutsas, whose youth and inexperience had made him a surprising choice as foreign minister. Also demoted was Louka Katseli, an American-trained economist who, as labour minister, had got involved in public disagreements with number-crunchers from the IMF.

Papandreou keeps order, just

Into the forefront of politics came a group of tough Socialists led by Evangelos Venizelos, formerly the defence minister, who has now been appointed finance minister. Mr Venizelos was once a rival of Mr Papandreou's, challenging him unsuccessfully for the party leadership after Pasok's 2007 election defeat. The burly constitutional lawyer, a powerful orator whose manner is both earthy and cerebral, took over from George Papaconstantinou, a technocratic figure who had become a liability because of his indefatigable efforts to carry out EU- and IMF-mandated reforms to the letter.

Mr Venizelos has held seven previous cabinet posts; he oversaw preparations for the 2004 Athens Olympics, which were considered a huge success in spite of serious cost overruns and a graveyard of white-elephant buildings left behind. In a passionate speech during the confidence vote, he caught public attention by saying that whatever the numbers might show, the government understood how desperate things were for many ordinary folk.

On the debit side, Mr Venizelos has never held a finance portfolio. And he annoyed his colleagues at his first meeting of euro-area finance ministers by suggesting, in a piece of posturing, that the euro zone needed Greece just as much as Greece needed the zone (see Charlemagne).

Will the new cabinet prove any more effective at reforming? The lenders' demands seem huge: cutting 150,000 public jobs and raising euro50 billion from privatisation sales by 2015. Job protection in the public sector and keeping control of state-owned utilities are two of Pasok's most cherished sacred cows. Mr Venizelos may chip away at the edges by closing

down some outdated state entities and selling shares in some profitable state companies. But the sweeping changes required by the EU and the IMF are unlikely to happen, at least in the short term.

Mr Samaras, as opposition leader, has taken an equivocal position. He argues that the medium-term budget targets are correct, but the methods proposed to hit them are wrong. The economy, he says, has already been squeezed to the point of collapsing.

The depth of Greece's recession, with the economy set to shrink by another 3.8-4% this year-more than projected-after dwindling by 4.5% in 2010, suggests that Mr Samaras has a point. The conservatives voted for more than a dozen pieces of legislation required under the current bail-out, but are insistent that they will vote against the new package. This stance infuriates both the EU and the IMF, who worry that if Greece's fractious politicians cannot unite even when bankruptcy threatens, then they have little chance of avoiding that fate.

Summer's respite

The stakes are rising. Greece needs to get a euro12 billion loan tranche by mid-July or risk being unable to pay wages and pensions at the end of the month. EU and IMF officials arrived on June 22nd to help fine-tune euro6 billion of emergency fiscal measures aimed at bringing this year's budget back on track, as well as the euro22 billion medium-term package-just as Mr Venizelos and Mr Papaconstantinou, now the energy minister, were tweaking some unpopular measures to make them more palatable to voters. Mistrust between Greece and its international lenders runs high, after months of near-standstill in Athens on the reform effort.

With his new government in place, Mr Papandreou has a good chance of winning the votes on the new package and an enabling law to ensure that individual measures can be implemented quickly. Greeks will then start feeling moderately hopeful that euro-zone finance ministers will sign off on the July loan tranche and, if all goes better than expected, even reach a deal on the second, euro100 billion-odd bail-out loan for their country.

The political mood in Greece improves almost automatically in July and August as the urban population heads en masse for family villages in the islands or mountains. There are few human woes that cannot be eased a little by exposure to the dreamlike beauty of the Aegean. But this year may yet prove an exception, especially if politicians and protesters alike insist on behaving as if they lived almost anywhere except on planet Earth.

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Financial contagion

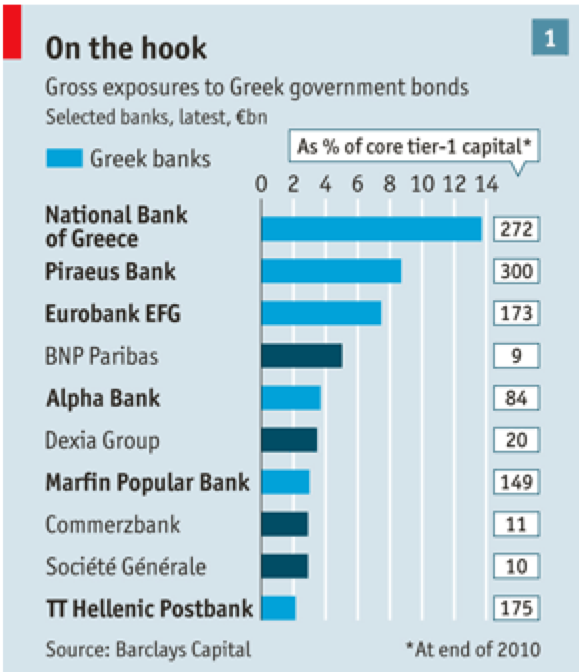
Fear of fear itself

Is this Europe's Lehman moment?

CONTAGIOUS diseases are usually dealt with by isolating the patient, lest he infect anyone else, and then by trying to treat the illness. Isolation is not always possible with physical ailments; with financial ills, it almost never is. With the Greek government perilously close to default, investors and policymakers are wondering whether European banks have caught something nasty. Many are comparing the choices facing the euro zone and the IMF to those faced by the American Treasury and the Federal Reserve in the days before Lehman Brothers collapsed in 2008, causing a seizure in the global financial system.

The comparison is not exact. The Greek government owes more than euro300 billion ($435 billion); Lehman's balance-sheet before its failure was $613 billion. The chief difference, though, lies in complexity rather than in scale. Wall Street's fourth-largest investment bank was at the centre of tens of thousands of interconnected trades that were hidden from view and difficult to value. Its fall caused panic because others in the markets had no way of knowing who the counterparties to its trades were and whether Lehman owed them so much that they too might fail.

That ought not to be true of Greece. It has far fewer creditors: two-thirds of its debt is probably held by about 30 institutions. And whereas Lehman's exposures were hidden from public view, Greece's are largely out in the open and are also reasonably easy to value. The more light has been shone into the dark vaults of banks holding Greek government debt over the past year, the more markets have been reassured that few, if any, foreign banks are dangerously exposed.



According to public data collected by Barclays Capital, an investment bank, few foreign banks' holdings of Greek government bonds are worth even 10% of their capital (Greek banks are a different matter: see chart 1). That means they should comfortably withstand the substantial losses that might arise if Greece said that it would repay less than 100 cents on the euro. Softer forms of default, such as extending the maturities of existing bonds, would probably cause almost no harm to the financial system, especially if the interest payments remained the same as when the bonds were issued.

Holdings of bonds do not tell the full story of banks' exposure to Greek government debt. By buying credit-default swaps (CDSs), which are essentially insurance policies against a default, banks are likely to have shifted some risk to insurers or investment funds that are less important to the financial system as a whole. Some banks, however, will have sold CDSs.

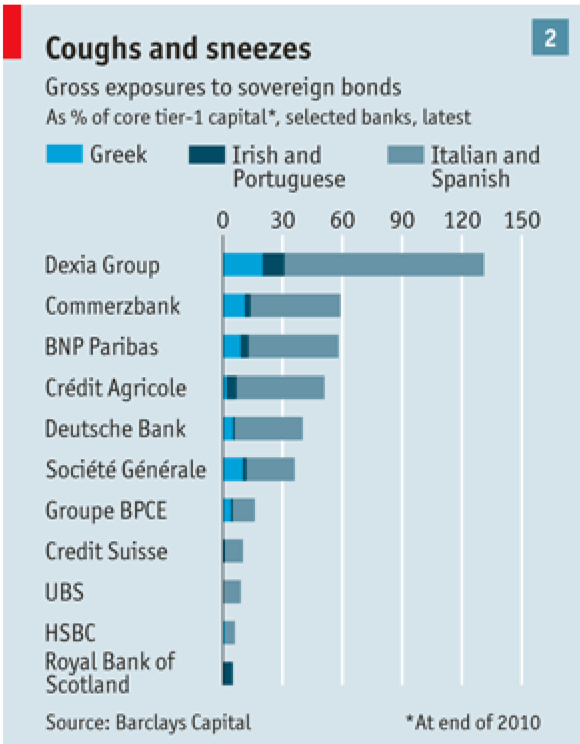
Across the entire financial system these CDS exposures largely net off, Barclays reckons, and collateral and margin-calls should have reduced the outstanding exposures to relatively small amounts. However, not everyone will end up with a net position close to zero. It is reasonable to suppose that there would be some large losses (and some large gains) on CDS contracts if Greece stopped paying its bills. Quite where these would emerge is causing some worry in markets.

Bank regulators have made progress in publishing information on exposures. Banks themselves have been giving quarterly or half-yearly updates on their ownership of Greek bonds. But weaker banks have been the most reluctant to come clean: public data on their holdings are a year out of date. Were panic to seize the banking system, regulators could do much to restore calm by releasing information they have collected in the past three months as part of "stress tests" of Europe's banks.

Government bonds are not the only assets on which foreign banks could lose money in Greece. Loans to Greek companies, made either directly or by their Greek subsidiaries, might also go bad. Foreign insurers as well as banks might suffer contagion, because they also own Greek government bonds. However, because Greece's insurance market is relatively small, most foreign insurers would have correspondingly small amounts of Greek debt.

The hard numbers alone thus suggest that a Greek default would do little lasting harm to the rest of Europe's financial system. Yet investors act on fear as well as figures. What is more worrying for Europe's policymakers is the thought that Greece's affliction would spread not just to foreign banks but to foreign governments. Just as Lehman's collapse told investors that a Wall Street bank could fail, a Greek default would tell them that a Western government could renege on its debts: Greece would be the first developed country to default for 60 years.

The European Central Bank (ECB) opposes a restructuring of Greek debt partly because of the risk that investors would then desert other troubled countries on the euro area's periphery. At the very least, their bond yields, which have already been rising, would climb further. They might also be pushed towards default.



First and second in line would be the next-wobbliest members of the euro zone: Ireland, whose government has debts of around euro150 billion, and Portugal, which owes euro160 billion. Partly because they have also reduced their holdings of Irish and Portuguese bonds, European banks should be able to cope if these countries joined Greece in default or in restructuring their debts. However, if contagion were to spread to Spain or Italy, and banks had to accept losses on their governments' bonds, the sums would look grim even for some banks outside the affected countries (see chart 2). Italy owes euro1.8 trillion, or 120% of a far bigger GDP than Greece's, Ireland's or Portugal's. Spain's debts amount to euro640 billion.

Another cause for unease is European banks' reliance on short-term wholesale financing from outside the continent. Fitch, a ratings agency, reckons that roughly half the cash entrusted to big American money-market funds is lent on to European banks. This is skittish money that can be gone in a trice.

Banks in vulnerable countries have already found money-market funding harder to come by, or at least dearer. Huw van Steenis of Morgan Stanley notes that a year ago, when European regulators last conducted stress tests, their "adverse" scenario assumed a fall in retail banks' earnings, before loan-loss provisions, of about 5%. "Almost every peripheral or southern European bank we've looked at underperformed [that] case," because of a rise in the cost of wholesale funding and deposits. Spanish banks have been turning increasingly to the ECB for funding, drawing euro57 billion at the end of May compared with euro42 billion in March.

Worse than jitters in the money markets would be a loss of faith by depositors. The Bank of Greece thinks that in the first four months of the year Greek banks lost deposits at the rate of euro2.8 billion a month.

Kill or cure?

What might happen if Greece defaults depends largely on how policymakers behave: the costs of contagion need not be big if panic does not take hold. The ECB could counter money-market flight, for instance, by supplying more liquidity, as the Fed did after Lehman crashed. It could also reopen the foreign-exchange swaps set up with the Fed during the crisis.

Some good ideas are already being discussed. One is to conduct credible stress tests and recapitalise banks that fail. On June 17th the IMF urged European regulators to speed up recapitalisation, warning that there is still a tail of weak banks.

Another idea is to increase the capacity for providing liquidity to countries on the periphery that seem solvent, yet risk being caught in the fallout from a Greek default. On June 20th the European Union restructured its interim bail-out fund, increasing its lending capacity to euro440 billion from an effective limit of euro260 billion by getting France, Germany and others to guarantee more of its debt. EU officials also encouraged the flow of private credit to Ireland, Portugal and Greece by saying that the fund would not be repaid before other lenders if debts were restructured.

Some policies, though, might cause trouble. The ECB has threatened not to accept Greek government bonds as collateral if the country's debt were restructured. If it carried out that threat, a liquidity crisis in Greece, bank runs and other mayhem could ensue. "It would be almost like an act of war," says a senior executive at a Greek bank. "I don't think that they'd pull the plug."

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Germany and the euro

Merkel's hazardous course

Greece's troubles are causing acute discomfort for Germany's chancellor

Between Scylla and Charybdis

THE streets of Berlin are quieter than those of Athens, but the euro crisis is making life almost as hellish for the German chancellor, Angela Merkel, as it is for the Greek prime minister, George Papandreou. Partly because of it, Mrs Merkel is going through her "roughest patch so far" in more than five years in office, says Renate Kocher of Allensbach, a pollster. Members of her coalition, consisting of her Christian Democratic Union (CDU), its Bavarian sibling, the Christian Social Union, and the liberal Free Democratic Party, are restive about the costs of saving the currency. The opposition is openly speculating, prematurely, that the government may fall.

The immediate danger is the wrangle over a second rescue for Greece. On June 10th the Bundestag endorsed a bail-out on condition that private investors make a "fair contribution". Even then, ten legislators from the coalition either voted no or abstained, a worrying dent in the government's 20-vote majority. Since then, Mrs Merkel's room for manoeuvre has narrowed. On June 17th, under French pressure, she endorsed the non-confrontational "Vienna" model, under which Greece's creditors are expected voluntarily to buy new Greek bonds as old ones fall due. That makes it less likely that they will make the large contribution that Mrs Merkel's parliamentary allies are demanding.

Television images of Greeks haranguing their government over reforms do not help. The protests make it "very difficult for MPs to explain the rescue measures to voters", says Klaus-Peter Flosbach, the CDU's fiscal-policy spokesman in the Bundestag. Nearly half the electorate favours throwing Greece out of the euro, according to a recent poll. Depending on how it is structured, the Greek rescue may not need explicit approval by the Bundestag, but there will be pressure to bring it to a vote. If that happens the coalition will support it, believes Mr Flosbach. "The MPs know what is at stake." The mood is fiercer in Finland and the Netherlands, which have influential Eurosceptic parties, German officials point out.

Even if the Greek hurdle is overcome, others loom. The Bundestag will vote later this year on whether to top up the temporary European Financial Stability Facility, which helped to finance the Irish and Portuguese bail-outs, and to create a permanent successor, the European Stability Mechanism (ESM). Many coalition MPs want every ESM rescue put to a parliamentary vote, which would make it unworkable. Germany's highest court is deliberating on complaints that the bail-outs violate the constitution and European law.

Mrs Merkel sees herself as steering between catastrophic alternatives. Hawkish demands for imposing losses on creditors or submitting every future bail-out to parliamentary scrutiny could endanger the euro. But the doveish idea that only "more Europe" will resolve the crisis is also distasteful. Mrs Merkel rejects fixes such as a finance minister for the euro area (an idea floated by Jean-Claude Trichet, president of the European Central Bank) or "Eurobonds" backed by every country in the zone. To spectators on both sides her cautious middle course, with its many abrupt corrections, looks directionless, defensive and eventually doomed.

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Egypt's economy

Light, dark and muddle

The shakiness of the economy could undermine progress towards democracy

FOR almost a month after the fall of Hosni Mubarak, the police vanished from the streets of Cairo. Integral parts of the reviled regime, they did not want to show their faces. Thanks to the self-discipline of Cairenes, there was little public disorder. But one thing did change: the traffic got even worse. With most of the traffic lights out and no cops, cars slowed to a crawl at every intersection.

Inadvertently, Egypt was trying out an idea from Dani Rodrik, a Turkish economist. Mr Rodrik compares a crossroads in Hanoi (but it could be Cairo) with one in Russia. In Hanoi, there are no traffic lights; cars and carts crowd into an impenetrable tangle, yet everyone gets through somehow. By contrast, in Moscow the lights work; columns of cars stop and advance in turn-right up to the moment some idiot in a truck runs a red light and smashes into the waiting queue. This happens again and again and again.

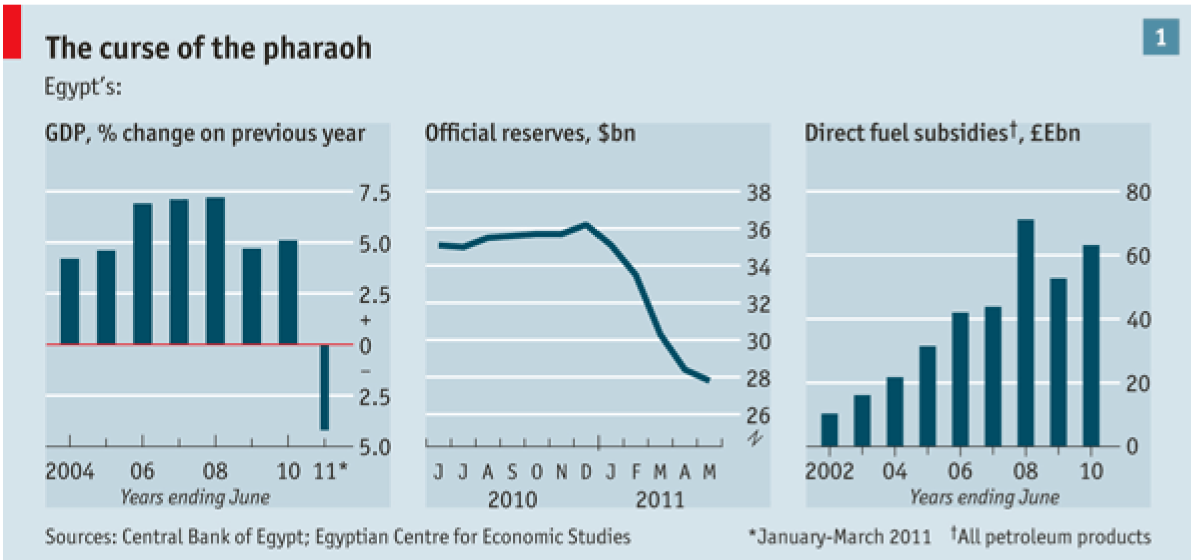
Egypt is now testing the merits of informality. The old corrupt rules are discredited. The government is running the economy from hand to mouth. It has no real mandate and lacks the confidence to tackle Egypt's deep-seated problems. It is getting by, more or less. But nobody knows if muddling through will work.

Much is at stake in Egypt economically, as well as politically. Like other Arab economies, the country has what might be called a patriarchal economy, with a weak private sector dependent on a dominant state one. Such an economy is the counterpart to autocracy, and in the economic sphere, just as much as in the political one, Egypt is a test for the Arab world. If it can prosper, others can too.

The economy also matters to democracy. Most people poured into Tahrir Square in January because of economic discontent, as well as for political reasons (at any rate, that is what they told pollsters from the International Republican Institute). Many Egyptians, argues Ahmed Heikal, Egypt's biggest private investor, underestimate the impact the economy is likely to have on the political system. If the economy improves, that should help consolidate democracy; if it falters, so will political reform.

It therefore seems all the more worrying that the first thing the economy did after the revolution was behave like a Russian truck. On January 25th, the day of the first big anti-Mubarak demonstration, an IMF mission had left Cairo saying the economy was motoring along. GDP was growing at 5% a year. The banking system was strong; so was the balance of payments (official reserves covered about eight months'-worth of imports).

After the uprising, GDP crashed, falling by 4% in the year to the first quarter. Manufacturing declined by 12%. Revenues from tourism collapsed, putting pressure on the balance of payments and starting a slide in foreign reserves (see chart 1). Official reserves have fallen by $9 billion this year, and the real figure may be higher (Egypt is thought to keep some reserves hidden). The government has estimated that it faces an external-financing gap of about $11 billion in the second half of this year and the first half of next.



How bad is this slump? A nine-percentage-point fall in GDP growth, from plus five to minus four, is less than some of the East Asian countries suffered after the recent financial crisis. Considering there was no public security for weeks, that banks and the stockmarket were closed, that strikes proliferated and investment collapsed as large numbers of leading businessmen were carted off to jail, things could surely have been worse.

Still, they were bad enough. The government faced immediate financing problems and the threat of a full-blown foreign-exchange crisis. Public expectations went through the roof, just as the economy's capacity to meet them collapsed. Ziad Bahaa el-Din, a former head of Egypt's investment authority who is now running for parliament, says that in his village 400km (250 miles) south of Cairo the young men have lost their hotel jobs and now sit around in the coffee house, mobiles in hand, waiting vainly for odd jobs. A backlash is growing. "We went to Tahrir Square and now we don't have any customers," laments Hany abd-el-Fattah, a tent-maker from Bab Zuwayla in Cairo.

The task of managing the mess has fallen to an interim government of technocrats, former opposition politicians and a few Mubarak holdovers. The circumstances look inauspicious. Though the government says it is laying the foundations for reform over three to five years, in reality it is only a stopgap administration, in office until elections planned for later this year. Though needing to make changes, it is cramped by hostility to the market reforms launched in the last years of the Mubarak regime. And though supported by demonstrators from Tahrir Square, it has no real mandate. It does not even seem to have the full backing of the military council that has the ultimate say over things in Egypt. The secretive generals-so far as one can tell-are mostly concerned with keeping the peace and deterring anyone who wants to stop them resuming their former position back-seat-driving the country. The result has been a government that is risk-averse to a fault.

Facing widespread demands for "social justice"-one of the few aims everyone can agree on-the government raised the top rate of income tax slightly and introduced a minimum wage of poundE700 ($118) a month. Egypt can probably afford this; poundE700 is equal to the poverty line and is low enough not to destroy jobs (though the amount is planned to increase). The government is also proposing a cheap-housing programme and a number of job-training stipends. Total social spending (including education and health) is to rise about 20% in the next 12 months.

Given the size of the slump, a temporary increase in the budget deficit is justifiable. And this one (a boost of two percentage points of GDP) is relatively modest-relative, that is, to the fiscal deterioration in rich industrialised countries after the 2007-08 slump. The IMF, at any rate, praised the budget.

And to give it its due, the government succeeded in forestalling the worst. There has been no bank collapse and no run on the pound. The stock exchange reopened without alarms. The foreign-exchange crisis is moderating: reserves fell $800m in May, compared with $3 billion in March. The government was also successful in raising $11 billion from foreign governments and international financial institutions. In fact, if you include all the various promises from Gulf states, the grand total could be over $20 billion-a remarkable vote of confidence in Egypt.

What subsidies do

Despite its limitations, the first post-Mubarak government had one precious-even unique-advantage. It came to power at a heady moment of change, when Egyptians were ready to accept painful measures as well as handouts. Its freedom of manoeuvre was greater than it seemed. It did not have to please a constituency of supporters, nor did it have to look for votes in a future election. At the very least, it had a chance to come clean about some of the hard choices facing the country.

That chance was lost. The government's first act was to approve a 15% public-sector wage rise proposed in Mr Mubarak's dying days. It boosted state pensions and gave 450,000 contract workers permanent jobs. The total wage bill could rise 25%. It is not clear the government could afford this. The problem is not just the cost of the bill but the message it sends: the government "comes across as trying to please as many people as possible", complains Ahmed Galal, the head of the Economic Research Forum, a think-tank.

It has also been inconsistent. It said it would implement a property tax proposed by Mr Mubarak and widely regarded as desirable. It then scrapped the idea under pressure from landowners. It proposed a capital-gains tax on dividend payments and scrapped that, too.

But its worst failure is over what Mr Heikal calls the elephant in the room: fuel subsidies. For years the government has sold every kind of fuel at below-often well below-world market prices, and paid the difference. It also subsidises bread and other staples. The direct costs are soaring (see chart 1): food subsidies now account for 2% of GDP; fuel consumes 8%. In all, subsidies cost almost three times the size of the education budget.

This is a grotesque distortion of national priorities. Fuel subsidies help the rich more than the poor. One driver of a gas-guzzler reckons the government gives him poundE150 every time he drives from Cairo to Alexandria. They keep alive uneconomic energy-intensive firms. They help businesses that need no help. Tourism takes a fifth of diesel subsidies, which are therefore fuelling air-conditioning in luxury hotels. In contrast, some of the poorest people in the country do not get the cheap food they are nominally entitled to because they live beyond the reach of the system that administers it. That system is made staggeringly inefficient by theft and leakages. A former finance minister said he could administer the subsidised bread programme only if he had one security guard for each sack of flour.

Cutting subsidies is hard. Some do help the poor, who need to be shielded from the cost of removing them. Immediate removal would also send prices spiking (though the deficit-financing cost is inflationary, too). But everyone knows the existing system is corrupt and that the country needs a targeted programme to ensure subsidies go to those who need them. Hania Sholkamy of the American University in Cairo got as far as setting up two pilot conditional-cash transfer programmes, one for 400 families in a Cairo slum, the other for 24,000 families in a poor region of Upper Egypt. Inexcusably, the new government shut them down, apparently because they had been started under the old regime. The government says it is planning a subsidy reform. But in the budget for 2011-12-its main economic programme-it did nothing. Indeed, it expanded the system to keep pace with rising world food and fuel prices. Subsidies will cost 9% more this year.

The government could and should have done better than this. It avoided the worst, and bought democracy some time. But it postponed decisions that need to be taken if Egypt's economic problems are not to worsen. Moreover, inflation and unemployment are bound to rise in the short term, partly because of the slowdown and especially because Egypt is vulnerable to rising commodity and fuel prices. So the next government is likely to be even more scared of change than today's. That government will be Egypt's first elected regime for decades. The last thing it will want to do is court unpopularity right away, and possibly imperil the fledgling democratic system.

Nonetheless, it will have to bite the bullet. To call Egypt's economy a failure would be too much, but it has not done nearly as well as it could. A fifth of the population lives on $2 a day or less, and another fifth lives just above that level. Almost everyone thinks the number of poor is growing. Neither they, nor the entrepreneurial middle classes, have benefited from what growth has taken place. Moreover, the cost of failing to produce new jobs is rising, as the babies born a generation ago (when fertility rates were higher) are entering the job market. The cohort of 15-20-year-olds is the largest among the population (see chart 2). If this demographic dividend is to be cashed, and if democracy is to take root, then living standards will have to improve.

As a measure of what is needed, compare Egypt with Turkey, a country of similar size (75m people) and, in the 1990s, similar economic performance. At that time, Turkey was roughly as wealthy as Egypt is now (its GDP per head at purchasing-power parities was $5,500; Egypt's is $6,300 at PPP). Like Egypt, it had persistent inflation (indeed, its record was worse). And for years its army lorded it over a series of weak civilian governments. Now Turkey's average income is $13,000, which puts it into the World Bank's category of rich economies. Last year 28m tourists visited the country. Egypt, with its pyramids and pharaonic treasure, got just 11m. If Egypt is to catch up, it will have to do what Turkey did: reduce the overweening power of the state and provide an environment in which private firms, especially long-suffering small and medium ones, can thrive.

The state's role is too large. Despite fitful periods of reform, the public sector still accounts for over 40% of value-added outside agriculture-higher than in most former communist economies. The state controls some prices directly and influences others through subsidies. The army controls an estimated 10-20% of the economy (no one really knows), including things like olive-oil and pest-control factories which serve no military purpose. And the government is hooked on deficit spending. Though the deficit has not risen much, it has long been too large, and is now 11% of GDP. Turkey's is 3%. Egypt needs to cut its deficit to near that level-which requires subsidy cuts.

Yet where a strong government is needed-as regulator, enforcer of contracts and guarantor of competition-it is weak. Its welfare provision is a shambles, with an incomprehensible tangle of entitlements which still leaves gaping holes in the safety net. The quality of state provision is an even bigger problem than its quantity. Only in the external sector (reducing barriers to trade and foreign direct investment) and, partially, in banking have reforms been successful.

One result is that private firms are knotted in red tape. Egypt comes 94th in the World Bank's "Doing Business" measure of regulations. Small and medium-sized companies cannot get credit from state banks. Many small firms do not even have bank accounts. The new government is planning to create a financial instrument for small firms. It is a start, but the next government will have to do a lot more.

It will also have to reverse the long-term failure of Egypt's education system, something beyond the remit of an interim administration. Once a centre of Arab learning and an exporter of teachers to the Arab world, Egypt has seen its education standards decline alarmingly. This is partly for lack of money-the country spends a smaller proportion of GDP on education than most Arab states-but is also a result of bad organisation. The quality of everything, from schools and

equipment to teachers, is appalling. The ministry of education employs as many bureaucrats as teachers, and there is no national teaching accreditation system. Educational failures cast a shadow over the quality of the workforce.

What are the chances that Egypt can rise to these challenges? In the long run, reasonable. The country has real advantages. It is the most populous Arab country and, because it is not dependent solely on oil, offers a bigger menu to investors. As a location-on the Suez Canal linking Europe, the Middle East and Africa-it is hard to beat. In common with other Arab countries, it has favourable demographic trends, with a growing labour force and a declining dependency rate (children and pensioners as a share of the working-age population). On the rare occasions the government started to liberalise-in 1974-79, 1991-98 and 2004-08-the economy boomed. "This is an economy that can bounce back," says Ratna Sahay, the head of the IMF's delegation to Egypt.

Destination Istanbul-or Karachi?

The big uncertainty is politics. Many Egyptians are optimistic, arguing that the removal of Mr Mubarak and plans for elections and a new constitution remove the biggest source of political doubt: what happens after the pharaoh. They also argue that there is a broad consensus supporting private-sector-led growth. A group called the Coalition of Revolutionary Youth, formed by Tahrir Square demonstrators, has a market-oriented economic policy to which all the main parties-including the youth wing of the Muslim Brotherhood-has signed up.

Which way now?

Yet this seems over-optimistic. Political uncertainty is everywhere. It is unclear whether post-Mubarak Egypt will have a presidential or a parliamentary system. It is not certain whether the elections will take place before the constitution is agreed (as the army says) or after (as liberals want). No one knows how much support the Muslim Brotherhood and the old-fashioned left have. No one knows how strong the temptations of populism could be.

On balance, if the politics stays stable, the economy should do well enough to consolidate democracy eventually. But that is a big if. As Mr Heikal says: "If we get things right, we could be Turkey in ten years. If we get them wrong, we could be Pakistan in 18 months."

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Health care

Mass observation

Health reform in Massachusetts, the model for Barack Obama's version, still has a long way to go before it proves itself

AFTER the economy itself, no subject counts for more in next year's presidential election than health care. Republicans universally detest Barack Obama's health reforms-which, though passed last year, will not go into effect until 2014-and vow to repeal them. Yet the reforms themselves are largely modelled on a measure first tried out in Massachusetts, and signed into law in 2006 by the state's then-governor, Mitt Romney (pictured above). Mr Romney is now the clear front-runner in the race to win the Republican nomination and face Mr Obama at the polls in 2012. Health care, in other words, could blow up in both candidates' faces, which makes the question of whether or not the Massachusetts reforms have worked particularly interesting. The evidence is mixed.

The first point to note is that the reforms are popular in Massachusetts, and not just with the left. "No one has a problem with it," shrugs Jim Klocke of the Greater Boston Chamber of Commerce. Sixty-three percent of residents support the law, according to the most recent poll from the Harvard School of Public Health.

This is due in part to the political climate. Benefits have long been generous in what conservatives mockingly call "Taxachusetts". In 2004, for instance, health spending per person, at $6,683, was 27% greater than the average for all states. Insurance coverage has also long been high. At the time of the reform Massachusetts had a small population of uninsured-just 6.4%, compared with 15.8% nationally.

The reform expanded coverage even further, with an individual mandate, penalties for employers who do not offer health coverage, an expansion of Medicaid (the state/federal health programme for the poor) and subsidised insurance for adults with incomes of up to 300% of the federal poverty level. A new exchange, Mr Romney hoped, would let workers use money from their firms to buy health plans that suit them. At the signing ceremony he grinned triumphantly beside Ted Kennedy, health reform's liberal champion.

Mr Romney left office shortly afterwards. Deval Patrick, his Democratic successor, has overseen the law's implementation. It has plainly succeeded in its main goal of expanding health coverage. Just 1.9% of residents lacked insurance in 2010. Other data, though, are more troubling. Access to health insurance does not guarantee access to health care. One in five working-age adults say they have trouble finding a doctor who will see them. The Connector, the state's exchange, has

excelled at enrolling uninsured adults in subsidised care, but has failed to attract small businesses and their employees. As of March just 3,644 workers bought coverage on the exchange through their employers.

Costs, meanwhile, are unsustainable. Spending on MassHealth, the programme for the poor, rose 40% between 2006 and 2010. The subsidised health programme for adults was more expensive than expected-$628m in 2008 and $805m in 2009, 32% and 11% above projections respectively. This was offset in part by falling costs for a smaller cohort of uninsured, who tend to turn up for treatment at emergency rooms from which they cannot, by law, be turned away: the figure dropped from $652 billion in 2006 to $414m in 2009. But the decline was less dramatic than many hoped, says Amy Lischko, a professor at Tufts University who helped write the law. And demand from the uninsured now seems to be rising. Last year the number of uninsured hospital visits reached 800,000, 14% above the level in 2009.

For those who do have insurance, average monthly premiums rose by 12% between 2006 and 2008. True, a higher share of firms now offer coverage, but they are also shifting costs for that coverage to employees. Various factors may be to blame. Clunky regulations for the health exchange failed to prompt competition, argues Robert Moffit of the Heritage Foundation. Low reimbursement rates for MassHealth may push hospitals to shift more costs onto the privately insured. And the state's attorney-general has found that hospitals are using their market dominance to push up prices.

The Patrick administration contends that the 2006 law was designed mainly to expand access; cost containment was meant to come later. With spending expected to double by 2020, "later" is arriving fast. But cutting costs is harder than improving coverage. Better coverage simply feeds more people into the health system. Containing spending requires turning the system on its head. After the 2006 reform Massachusetts passed a few minor provisions to lower costs. Glen Shor, the new director of the exchange, is making changes to attract more small businesses. But in the past year Mr Patrick has begun what may be America's most aggressive effort to slash spending.

He started last year by telling his insurance commissioner to begin blocking premium increases. "It wasn't a permanent solution," Mr Patrick says, "but we did get everybody's attention." In February he presented a bill to cut costs by rejecting high premiums in the short term and transforming health payments in the longer term. Mr Obama's reform includes similar provisions, with a plan to review premium increases above 10% and a programme to reward hospitals and doctors for providing good, inexpensive care. But Mr Patrick's plans are more ambitious, with a powerful role for his insurance commissioner and a bolder plan to redirect most spending from fee-for-service models by 2015. State employees and MassHealth would make the shift even earlier.

The proposals have prompted strong reactions. Innovation may be stymied by price controls that distort the market, argues Michael Widmer of the Massachusetts Taxpayers Foundation. Lowell General Hospital is one of several providers that have worked with Blue Cross Blue Shield, the state's biggest private insurer, to test a new type of payment. But Lowell's president, Norm Deschene, worries that the governor's prescriptive rules will thwart his efforts. "It's a one-size-fits-all approach," he complains.

This debate will surely escalate as legislators present their own plans to compete with Mr Patrick's. Massachusetts has already shown that expanding access is complicated. As it struggles to rein in costs, the rest of America will be watching closely.

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Ethanol subsidies

Fiscal sobriety

A bipartisan vote to end ethanol subsidies is a small but heartening sign

TWO of the iron rules of American politics are that Republicans don't vote for higher taxes and only the foolhardy vote against Iowa. Both were broken on June 16th when senators from both parties voted by sizeable margins to repeal a tax credit and tariff on ethanol.

Since 2004 blenders have received a credit, now worth 45 cents, for each gallon of ethanol they mix with regular gasoline (petrol). Most of the benefit flows down to farmers. And since 1980 domestic producers have also been protected by a 54 cent tariff on imports, which serves to keep out ethanol made more cheaply from Brazilian sugar cane.

Defenders say the credit and tariff reduce American dependence on imported fossil fuels and reduce carbon dioxide emissions. But it is an inefficient way to do both. Because ethanol produces less energy than petrol and requires the burning of fossil fuels in its production, and because ethanol would still be used without a credit, the taxpayer pays about $1.78 to reduce petrol consumption by one gallon via corn-based ethanol. Taking everything into account, ethanol releases almost as much carbon dioxide as petrol does. As Michael Greenstone, the director of the Hamilton Project, a liberal research group, puts it, "Ethanol is largely farm support policy, not environmental policy."

It survives thanks to the political clout of corn-growing Iowa, which is both a swing state and the first to select delegates during the presidential primary season, and to Republican reluctance to do anything that looks like raising taxes.

But Iowa has seen its clout diminish as some Republican presidential contenders have chosen to avoid the state. In any case, with corn prices near records and a federal mandate that requires refiners to blend a growing amount of biofuels with petrol, neither farmers nor the ethanol industry will suffer much.

America's sky-high deficit has also changed the equation on taxes. Several bipartisan groups have recommended eliminating tax credits and exemptions, which together cost roughly $1 trillion a year in foregone revenue, as a less harmful way to reduce the deficit than raising marginal tax rates. That so many Republicans agreed in the face of opposition from Americans for Tax Reform, a potent anti-tax group, is a watershed. "The days of placing spending programmes in the tax code and giving them holy status are over," crowed their leader Tom Coburn, a Republican senator from Oklahoma. The vote has heartened some in Barack Obama's administration who are counting on a higher tax take to sell Democrats on the deficit reduction Joe Biden, the vice-president, is now negotiating.

They should not take too much comfort. The House of Representatives opposes the measure, though more over procedure than substance. Mr Obama's views are unclear. And at $6 billion a year, the credit is a pipsqueak. Still, as Mr Greenstone says, the vote was "quite good news for the small set of people who are both carbon and budget hawks."

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California's budget crisis

Kabuki without end

State legislators go unpaid as California reverts to dysfunctional type

WHAT a lot of history California has been making this month. For the first time since 1933, the (Democrat-controlled) state legislature has the power to enact a budget with a simple majority, thanks to a ballot measure voters approved last year. So it passed a budget on June 15th, meeting the constitutional deadline-also for the first time in years. But the next day Governor Jerry Brown, himself a Democrat, vetoed that budget-apparently the first such veto in California's history. The budget was not balanced, he said, and contained "legally questionable manoeuvres".

His fellow Democrats scolded him. Mr Brown scolded them back, and the Republicans to boot. The Republicans were already scolding everybody, and saw no need to stop. Joining this free for all, the state's independently elected state controller, John Chiang, decided to stop paying legislators. The new budget rules require withholding salaries from legislators for every day that a budget is late, he said. But our budget was not late, the legislators objected. Your budget had gimmicks and was not even balanced, Mr Chiang told them. He will get sued for his pains, it goes without saying.

Mr Brown's Republican predecessor, Arnold Schwarzenegger, used to call the ritualised drama that is California's budget process a "kabuki". But Japanese kabuki plots only start ridiculous and complicated, before speeding up and resolving themselves with a cathartic bang in the fifth act. California will be lucky if it follows such a script. Indeed, Mr Brown's second spell of governorship now runs the risk of failing in its first year.

Here is how the year has deteriorated so far. In January, facing what was then a deficit of more than $25 billion, Mr Brown proposed to solve half the problem by cutting spending and the other half by extending some temporary taxes. For the cuts, he expected support from his fellow Democrats. For the revenues, he did not ask for support from hostile Republicans, merely for their consent to put that question before voters in a special election, which requires a two-thirds majority in the legislature. The Democrats duly enacted their part, the cuts. But the Republicans refused to agree to put the revenue question to voters. A handful of them almost broke ranks, but then retreated into the safety of their caucus.

All through this the polls, which at first showed support both for the governor and for his proposed tax extensions, have been turning against Mr Brown. This undermines the strategy of going for a special election, even if he could still get one, since voters would probably reject the revenues anyway. Meanwhile, the economy and tax receipts have grown just enough to make Mr Brown's argument look weaker and to shrink the remaining budget hole-to about $10 billion-but not nearly enough to solve the problem.

So there they are. The new fiscal year starts on July 1st, and California had no budget as *The Economist* went to press. Standard & Poor's, a rating agency, says that California's credit, at A- already the worst among the 50 states, is "at a crossroad". Voters are angry. So are legislators. So are the governor and his wife, though presumably not their new dog, Sutter. That, though, is about the only bright spot.

Political conferences

Revving up the bases

Auditions down south and tactical debates up north, as activists on both sides plot a course for the coming election

Fired up, ready to blog

A DEMOCRAT sits in the Oval Office, preparing to run for re-election. Barack Obama is a formidable campaigner and fund-raiser. In 2008 his campaign raised a record $745m; this time his haul may exceed $1 billion. Gearing up to oppose him are a squabbling bunch of Republicans, united in relative obscurity save for the front-runner, Mitt Romney. By rights the left-leaning Netroots Nation gathering should have been jubilant, and the Republican Leadership Conference (RLC) doleful and panicky.

But that would overlook the left's capacity to rain on its own parade. Despite the big Democratic reforms of the past few years, the left-or at least the roughly 2,400 lefty bloggers who attended Netroots Nation-often sees the Obama administration as hesitant and incrementalist. Joan McCarter, who moderated a panel called "What to Do When the President is Just Not That Into You" (the title comes from a popular romance/self-help book), said that Mr Obama has been "not necessarily as progressive as we hoped he would be".

But progressives may also have been more docile than Mr Obama had reason to expect, and a running question at the conference was whether activists should defend or put pressure on the president. Recommending pressure was Dan Choi, a former army linguist who was discharged in 2010 after coming out as gay. He had become the country's most prominent advocate for a repeal of the military "Don't Ask, Don't Tell" policy, and that same year was arrested after handcuffing himself to the White House fence. "We were drama queens, and we were damn proud of it, and our message was, 'We're going to get crazier'," Mr Choi explained. The policy was repealed some months later, although the repeal has not yet been implemented.

Defenders of the more cautious approach-and there were many-may be motivated less by love than by fear. Mr Obama may not be perfect, but even gloomy progressives realise he is better than the alternative. "Imagine the enforcement and regulating of the Affordable Care Act under President Rick Perry," cautioned Eve Gittelson, a blogger from New York, at a panel on health reform.

As it happened, among the Republicans so imagining at the RLC in New Orleans was Mr Perry himself, in his third full term as governor of Texas and mulling over a presidential run. He warned that while states may face financial trouble now, "they're going to pale in comparison to what we'll see in 2014 when that runaway train known as Obamacare hits our budgets." Mr Perry was one of eight potential candidates to speak at the conference. Neither Mr Romney nor Tim Pawlenty attended, and Jon Huntsman cancelled his appearance at the last minute. He and Ron Paul, standard-bearer for the party's libertarian wing, were the most rapturously received: Mr Perry left the stage to chants of "Run, Rick, run!", while Mr Paul won the conference's straw poll by a hefty margin.

Such victories are nothing new for Mr Paul, whose supporters are passionate and flock to such party conferences, and he is no more likely to translate them into broader electoral victory this year than he has been in the past. Mr Perry, however, might prove a formidable candidate. He has the executive experience of Messrs Romney and Huntsman but lacks their political baggage-Mr Romney's health-care reform, Mr Huntsman's service to Mr Obama as an ambassador-and their Mormonism, which is still suspect to many Christian conservatives. He has tea-party credibility, but boasts a far longer and more impressive track record than Michele Bachmann, Herman Cain or Rick Santorum. In a weak and divided field-it is hard to imagine a supporter of Mr Paul succumbing to Mr Santorum's religiosity, or a fan of Mr Romney's country-club Republicanism finding much to like in Mrs Bachmann's pitchfork populism-room exists for an all-things-to-all-men candidate such as Mr Perry.

Democrats should take no comfort from that divided field. In 2008 John McCain had the Republican nomination sealed by mid-February, while the battle between Mr Obama and Hillary Clinton dragged into June. Egos were bruised, but the base was motivated for the general election. Sometimes, true love waits.

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Charter schools and the NAACP

Advancing coloured people?

A teachers' union and a civil-rights group take on charter school expansion

The battleground

COLUMBIA, New York University and the Universities of Michigan and Oregon are colleges six-year old Alexander Ferguson is considering attending come 2022, brags his mother Iris Ayala. But because of a lawsuit affecting charter schools in New York City, it is not clear if Alexander's current school, Harlem Success Academy, will open after the summer break. A teachers' union and the National Association for the Advancement of Coloured People (NAACP), a civil-rights group, filed a lawsuit last month to stop 22 failing schools from closing and also to prevent 19 charter schools from moving in with existing district schools. (Charter schools are independently managed but government-funded.)

The lawsuit claims that the city's Department of Education did not follow state law in deciding on the closures and assigning the 19 "co-locations", which it denies. The NAACP is involved in the case because co-locating with charter schools, it says, is akin to segregation. To accommodate the charter schools, the plaintiffs claim, district schools lose library time, give up space and oblige children to eat lunch at 10am so that charter schools can use the cafeteria at normal lunch time.

In reality, many existing school buildings are underutilised. Concessions on space get made on both sides. And it is not just charter schools who share space; nearly half of the city's public schools-751 of 1,675-share space in buildings. Dennis Walcott, New York's (black) schools boss, is bewildered by the NAACP's stance, especially as the vast majority of charter school students are black or Latino, the very children the NAACP wants to help. Stanford University released a study last year which found that New York City's charter schools produce "significantly better results" for their students in reading and in maths than traditional schools. The results also show that black and Latino children in New York charters do significantly better in reading and maths than in regular schools. We are "hitting it out of the ballpark", says Eva Moskowitz, who runs seven charters in Harlem.

Harlem, still a NAACP stronghold, has become an education battlefield. Last month some 3,000 parents turned out with banners to urge the NAACP to drop the suit. Ny Whitaker, whose son attends a Harlem charter school, says the "NAACP is on the wrong side of history". The NAACP brought the landmark *Brown v Board of Education* case which ended segregation before the Supreme Court, but Hazel Dukes, head of its New York chapter of NAACP, surely over-reacted when she accused one charter parent of "doing the business of slave masters".

The union and the NAACP removed three charter schools from the suit on June 21st, including two of Geoffrey Canada's renowned Promise schools, possibly in an attempt to draw some of the sting from their actions. A temporary injunction has halted the closures and planning for building-sharing is temporarily on hold. A hearing on June 30th is likely to decide whether the plans can go forward again. The presiding judge has said that it is not up to the courts to decide if charters and co-locations are good or bad, but merely to determine if the law was properly followed. But if the co-location plans are stopped permanently 7,000 children will be left in the lurch. Which will not do much for young Alexander Ferguson.

Cutting legal costs

The paper chase

Lawyers abusing procedures on evidence slow justice to a costly crawl

AMERICA thinks of itself as having not only liberty, but "justice for all", as the Pledge of Allegiance has it. The World Justice Project disagrees, releasing a report on June 13th on the status of the rule of law in 66 countries around the world. America ranked in the top echelon in many categories. For example, it got high marks for open government, limits on government powers and "order and security". But on access to civil justice, America did badly: it came 21st, just behind the Czech Republic and just ahead of Jordan. The cost of the system was the most important thing dragging America's score down.

America is rightly considered litigation-happy. Opening a case is easy. But once begun, many factors conspire to make the process expensive and frustrating. Ambulance-chasing lawyers and runaway juries are only part of the problem, and probably not the most crucial one. Less than 2% of federal cases result in a trial. The worst problem comes in the pre-trial phase known as discovery.

Once a suit is filed and the defendant answers, the parties to a suit have an extensive right to demand information from each other. This includes written questions to the other side, depositions of witnesses, and demands for documents the other might have. The rules presume a right to nearly anything in the other party's possession that might conceivably be relevant. The right to discovery has been used by aggressive lawyers not just to find pieces of information, but to exhaust and impoverish adversaries through endless motions for more.

The problem has worsened since the proliferation of digital information has made discovery more complicated and expensive. E-mails, financial records and other databases are all subject to discovery. Some records are automatically archived; some are routinely deleted. Clients may not always know exactly what they have. But if a court finds out that parties have failed to produce discoverable information, the sanctions can be severe. These can include an automatic negative inference about the missing information, dismissal of the case, or heavy fines.

This leads lawyers to practice the legal equivalent of "defensive medicine", producing far more than they need to to stay on the safe side. Clients foot the ever-growing bills (e-discovery services are now a business estimated to be worth between $1.2 billion and $2.8 billion) as the lawyers ratchet up their demands of each other. Even the stronger party in a case has a strong incentive to settle, to avoid the time and cost.

So ever fewer cases are going to trial: the ratio of federal trials to initial filings in 2009 was a twelfth of what it was in 1962. States courts have held far fewer trials, too. This has led the Institute for the Advancement of the American Legal System, an advocacy group, to lead a call for reform. The IAALS wants stronger enforcement of the principle of proportionality. This rule (already on the books, but not much used) dictates that discovery requests should be in line with the sums of money at issue. Second, they want to raise the bar at the pleading stage: litigants should put all the information they have forward at the outset. This should smoke out more of the bad cases, so that those that survive are more likely to reach trial, and lawyers will focus on the merits, not discovery ambushes.

The Seventh Circuit courts (in Illinois, Indiana and Wisconsin) are testing some of these ideas in a pilot project. In it, an "e-discovery liaison" is appointed from each party at the start of a case. Lawyers must meet and try to co-operate with each other before they see a judge. Following positive reports the pilot is being expanded into a two-year second phase with three dozen judges participating, and a report due out May 2012 which will see if the new rules lowered costs.

Better procedures alone are not sufficient to reform American justice. But stopping lawyers from throwing sand in the gears is a necessary step. Even the American College of Trial Lawyers has joined the IAALS in supporting the changes. Trial lawyers make money in discovery, too. But they get into the business to argue cases in courtrooms, not to file endless papers.

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The decline of marriage

For richer, for smarter

The traditional family is now the preserve of a minority

MARRIAGE, and its many ups and downs, still exercises a powerful hold over newspapers, magazines and the airwaves. Nearly 23m Americans watched Prince William being joined in holy matrimony to Kate Middleton. Millions more have wallowed in the break-up of Arnold Schwarzenegger's marriage after revelations that he fathered a son with a maid. And the tumescent tweets of congressman Anthony Weiner have stirred up endless speculation about the health of his own year-old marriage and the forbearance of his newly pregnant wife.

Less titillating are revelations about the sorry state of marriage across the United States. Data from the Census Bureau show that married couples, for the first time, now make up less than half (45%) of all households.

The iconic American family, with mom, dad and kids under one roof, is fading. In every state the numbers of unmarried couples, childless households and single-person households are growing faster than those comprised of married people with children, finds the 2010 census. The latter accounted for 43% of households in 1950; they now account for just 20%. And the trend has a potent class dimension. Traditional marriage has evolved from a near-universal rite to a luxury for the educated and affluent.

There barely was a marriage gap in 1960: only four percentage points separated the wedded ways of college and high-school graduates (76% versus 72%). The gap has since widened to 16 percentage points, according to the Pew Research

Centre. A Census Bureau analysis released this spring found that brides are significantly more likely to have a college degree than they were in the mid-1990s.

"Marriage has become much more selective, and that's why the divorce rate has come down," said Bradford Wilcox, director of the National Marriage Project at the University of Virginia in Charlottesville. The project found that divorce rates for couples with college degrees are only a third as high as for those with a high-school degree.

Americans with a high-school degree or less (who account for 58% of the population) tell researchers they would like to marry, but do not believe they can afford it. Instead, they raise children out of wedlock. Only 6% of children born to college-educated mothers were born outside marriage, according to the National Marriage Project. That compares with 44% of babies born to mothers whose education ended with high school.

"Less marriage means less income and more poverty," reckons Isabel Sawhill, a senior fellow at the Brookings Institution. She and other researchers have linked as much as half of the income inequality in America to changes in family composition: single-parent families (mostly those with a high-school degree or less) are getting poorer while married couples (with educations and dual incomes) are increasingly well-off. "This is a striking gap that is not well understood by the public," she says.

Do not expect the Democratic Party, however, to make an issue of the marriage gap in next year's elections. Unmarried women voted overwhelmingly for Barack Obama. "You don't want to suggest to someone who isn't married and has children that they should be married," says Ms Sawhill. "That is a denigration of their lifestyle."

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Lexington

Mars in the descendant

America is tired of war. That would suit Barack Obama, if not for the one he entered in Libya

"I VENTURE to say that no war can be long carried on against the will of the people." Edmund Burke should be alive today. None of America's several wars is popular. According to a Pew Research poll this week, a majority of Americans (56%) now believe that their troops should come home from Afghanistan as soon as possible. Only 39% favour waiting for the situation there to stabilise, even though most still think that the original decision to go to war was right. In the case of Libya there was never any equivalent enthusiasm to intervene in the fighting between Muammar Qaddafi and the rebels. And most Americans are delighted that the present plan is to quit Iraq by the end of this year.

America has reason to be war-weary. Since September 2001 it has spent some $1.3 trillion on the wars in Iraq and Afghanistan, in which some 6,000 service personnel have died. Even conservative Republicans, the group keenest on "staying the course", have started to tell pollsters that America should pay less attention to problems overseas and more to the growing ones at home. In their New Hampshire debate several Republican presidential candidates joined the cry to bring the boys home-"as soon as we possibly can," said Mitt Romney, the putative front-runner.

For Barack Obama, these signs of Republican softening are a godsend. Many in his own party hate the war in Afghanistan. Some were aghast when, in 2009, he ordered the deployment of 33,000 more troops in an Iraq-style "surge". He always planned to announce the return of some of them this summer. But too fast a withdrawal would have exposed him to charges of wavering against al-Qaeda. Now the Republicans' own wobbles, the killing of Osama bin Laden, the public's spreading war fatigue and the transfer of the gung-ho General David Petraeus from Afghanistan to the CIA have given the president unexpected flexibility.

On June 22nd Mr Obama announced that all the surge troops will be out by the end of next summer. This will leave about 68,000 behind, and Mr Obama where he wants to be as the 2012 election nears: out of the "dumb" war in Iraq and carefully but visibly winding down (see Banyan) the one in Afghanistan. The tide of war is receding, says Mr Obama; now it is time for nation-building at home, "to reclaim the American dream".

At home, however, the least costly of America's wars, the one in Libya, is turning into a serious headache. Mr Obama's grounds for intervening were simple enough. Only America had the means to stop Colonel Qaddafi from perpetrating a massacre in Benghazi. But this war was never popular. Many Democrats, traumatised by Iraq, say that such ventures are bound to fail, however noble the cause. Many Republicans hold that the nobility of the cause is itself the problem. With no vital American interest at stake, argues Michele Bachmann, another of the Republicans' presidential candidates, the "Obama doctrine" has set a precedent for American intervention in "one country after another".

Going into one country after another is in fact the last thing on the mind of this hyper-cautious president. No American drones are stopping the slaughter in Syria. Even in Libya Mr Obama was a reluctant warrior. He acted only when Benghazi was on the brink of falling, and only after securing cover and help from NATO, the UN and the Arab League. He also insisted that America's European allies, who had goaded him into the war, should take over the chief responsibility for it in short order. If Libya was going to end in a mess, the president who inherited the messes in Iraq and Afghanistan wanted someone else to be in charge of it.

It all made perfect sense, at the beginning

The trouble is that Libya's dictator has hung on-perhaps precisely because the superpower has chosen to stand back. And standing back has meanwhile not earned Mr Obama the political credit he hoped for. If anything, the opposite has happened.

The White House boasts that since early April America has had only a "non-kinetic", "supporting" role in Libya. It has no troops on the ground and is not exchanging fire with hostile forces (unless you count the odd drone strike). That makes the war cheaper for America while allies do the dirtier work-the opposite of the dismal pattern in Afghanistan. This looked like a perfectly splendid arrangement, until one of Mr Obama's advisers was quoted as describing it as "leading from behind".

Such a phrase should never have been uttered in the hearing of a journalist. Since its publication in the *New Yorker,* "leading from behind" has become a prime exhibit in the Republicans' scornful excoriation of Mr Obama's foreign policy. The president now finds himself accused of being both a warmonger for entering the war and a wimp for his lame prosecution of it.

To make matters worse, he now denies that it is a war at all. Under the War Powers Resolution a president must ask Congress's permission if hostilities last more than 90 days. That deadline fell on June 17th, but Mr Obama did not ask, on the eccentric ground that America's "supporting role" no longer amounts to "hostilities". This has outraged even the war's supporters, especially since the disclosure that Mr Obama overruled the lawyers in the Justice and Defence Departments and turned to more pliant ones in the White House and State Department. Bruce Ackerman, a professor of law and political science at Yale, said in the *New York Times* that this could open the way for "even more blatant acts of presidential war-making in the decades ahead".

It is odd. A weary America has adopted Mr Obama's wary instincts in foreign policy. He is making a good fist of extricating America from the big wars he inherited from George Bush. But the tiny one he entered so cautiously himself, in which not a single American soldier has died, has brought him disproportionate grief. Even before it disposed of bin Laden, America had lost its appetite for venturing abroad in search of monsters to destroy.

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Security in Central America

Rounding up the governments

Central America's leaders and their neighbours are at last starting to co-operate. But the mafias still lead the way in regional integration

THE Central American isthmus is smaller than Texas. But the seven countries crammed onto the bridge between the Americas seize nearly 100 tonnes of cocaine a year, more than all of Europe does. Another 200 tonnes or so make it through undetected, supplying 90% of consumer demand in the United States. The drug trade, combined with mainly weak states, brings a grim human harvest. In 2009 the isthmus saw nearly 19,000 murders-or 45 per 100,000 people, making it the most violent place in the world.

While the mafias are untroubled by national boundaries, Central America's governments bicker over them. Last year Nicaragua and Costa Rica almost came to blows over a border incursion by a Nicaraguan river-dredging party. A coup in Honduras in 2009 caused a regional rift that was only patched up last month. Co-operation has been woolly. A first effort to produce a joint-security strategy last year came up with more than 200 "priorities". In contrast, the drug mobs (who also traffic everything from people to historical artefacts) are experts at regional integration. Last month 27 farmworkers were beheaded in Guatemala's northern Peten province by a Mexican gang.

Central America's leaders and their foreign allies are now trying to catch up. Seven Central American presidents, plus those from Mexico and Colombia, as well as Hillary Clinton, the American secretary of state, and other foreign ministers gathered this week for a conference in Guatemala City, replete with promises of more co-operation and more cash. "We haven't seen this level of interest in Central America since the cold war ended," says Ennio Rodriguez of the Inter-American Development Bank (IDB).

The conference agreed a blueprint to fight and prevent crime, improve prisons and strengthen institutions, partly through a wish-list of joint regional projects. The leaders also agreed a follow-up scheme to keep up pressure to integrate security policy. Barriers are slowly coming down. El Salvador already allows Guatemalan police to cross into its territory, albeit usually accompanied by Salvadorean officers. Army chiefs in Guatemala, Honduras, El Salvador and Belize now speak to their opposite numbers without having to go through their foreign ministries. Mexico shares access to its intelligence database, and trains police at its academy. (It has ruled out "hot pursuit" on Mexican soil, however.)

El Salvador and Honduras are said to be studying Guatemala's UN-sponsored International Commission against Impunity (CICIG), a unit charged with investigating and prosecuting the criminal networks that have infiltrated the state. Equivalent missions in those countries are unlikely partly because of the cost ($20m per year), but also because some at the UN are said to be concerned that CICIG has overstepped its remit. One option being touted is a regional rapporteur who would monitor anti-crime strategies.

A lack of trust means that co-operation often only happens if the presidents themselves get involved. That is partly because civil services are purged with each new administration. "In Central America we've not yet learned to distinguish between the institutional scaffolding of the state, and its employees," says Eduardo Stein, a former vice-president of Guatemala. "That lack of continuity is catastrophic for regional co-operation." Agreement on policy is easier than action, he adds: "thousands of regional presidential directives have never been implemented."

More money is needed too. So far this year the Guatemalan government has seized guns, drugs and cash worth 9% of its annual GDP. (In 2010 the figure was 5% for the whole year.) Narco-flights to jungle runways in Peten have diminished (most now land on Honduras's Mosquito Coast), but sea traffic remains. "Even if you add all the navies of Central America, you don't have enough to police the Caribbean and the Pacific," says Alvaro Colom, Guatemala's president.

Donor countries are not flush with cash. The United States, which spent up to $1.1 billion a year on "Plan Colombia" a decade ago, has disbursed to Central America little more than a tenth of that sum over each of the past three years. But Mrs Clinton promised "almost $300m" this year. All in, donors pledged almost $1 billion for security this year. On paper, at least, that is a big increase from the $160m that the UN Development Programme (UNDP) reckons was actually spent last year. Most foreign aid and loans for security still go to individual countries, rather than to regional efforts. That may now change a bit.

Much of the new money will come from development banks, which increasingly see security as part of their remit. The IDB offered $500m over the next two years to support the new security plan. Its loans already bankroll Costa Rican prisons and mobile phones for the Honduran police. The World Bank promises to step up lending to Central America too. A bank official says that funding police-training in Central America, as the IDB does, would be against the bank's rules. But it may soon extend projects supporting civil justice to criminal justice, hitherto off-limits.

Central American governments have been doing more themselves. Their security spending totalled $4 billion last year, up 60% in nominal terms from 2006, says the UNDP. About a fifth of public spending on Guatemala now goes on security, but low taxes mean that this is not nearly enough.

Noting that "true security cannot be built on the backs of the poor", Mrs Clinton urged that "businesses and the rich in every country must pay their fair share of taxes." If only. Mr Colom admits he is unlikely to secure fiscal reform before he steps down in January. El Salvador's government wants a security tax, similar to one in Colombia, but it too faces right-wing opposition. Costa Rica's divided congress is stalling on new taxes. The conference will help presidents press the private sector and legislatures to get serious about public security, says an official from the Central American Integration System, the regional body which convened it. Until they do Central America's biggest business by far will be an illegal one.

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Protests in Bolivia

Car crash

Evo Morales tangles with the taxi drivers

REAL power in Bolivia often seems to lie with the *transportistas*, the owner-drivers of buses and taxis who ferry people and goods around a big, sparsely populated country of difficult geography and alarming roads. Twice in recent months they have clashed with Evo Morales, the country's socialist president, who has a record of successfully dispatching his political opponents. Both times the *transportistas* have won.

The first clash was in December, when the government announced a steep rise in the price of petrol only to back down within days. The second has involved a tortuous row over imported second-hand cars. Three years ago Mr Morales banned imports of the oldest among these smoke-belching jalopies, to cut air pollution and traffic congestion.

But this month the government performed a U-turn, and declared a 25-day amnesty in which owners could register illegally imported vehicles and pay a fine. That recognised reality. The ban notwithstanding, Bolivia's roads are choked with unregistered vehicles, which skip road tax or use false number plates. Last month the police chief was fired after it was revealed that some of his officers were providing the plates.

The amnesty sent Bolivians flocking to Iquique, the Chilean port where most of the imports arrive, until car dealers there sold out. Some frustrated would-be buyers turned to stealing Chilean cars. That prompted Chile's senate to pass a motion of protest at Bolivia's "laundering" of stolen vehicles, a complaint echoed in Brazil and Paraguay. Bolivia's customs service says that over 80,000 vehicles were registered in a fortnight.

The amnesty also angered Bolivia's taxi drivers, who fear competition from the new imports. "The cities will collapse," predicts Raul Alcoba, a drivers' leader. The *transportistas* called a one-day strike. So the government swerved. It issued a decree banning the use of vehicles more than 12 years old for public transport. But that covers 95% of buses and taxis, say the *transportistas*. Although the decree gave them seven years to adjust, they called an all-out strike.

Mr Morales blinked yet again. After talks, he apologised for his "mistake". He promised full consultation over a new transport law, plus beefed-up vehicle inspections. He may hesitate before taking on the *transportistas* a third time.

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Protests in Chile

Marching on

The discontents of a healthy democracy

YOU can hardly walk down Santiago's main thoroughfare, the Alameda, these days without coming across someone with a protest banner and a grievance. Last month some 30,000 people marched against the government's decision to approve the building of a giant hydroelectric plant in pristine Patagonia. On June 16th 80,000 students, teachers and sympathisers demanded more money for state education in what was reported to be the biggest protest march since the mid-1980s, when Chileans braved General Pinochet's water cannon to demand a return to democracy. Subcontracted workers from a big copper mine, El Teniente, and farmers have also taken to the capital's streets.

This surly mood was reflected in an opinion poll taken last month by Adimark, which showed approval of the president, Sebastian PiÃ±era, down to 36%, from 63% last October when he basked in the successful rescue of 33 miners in the Atacama Desert. His disapproval rating of 56% is now the highest of any president since the return to democracy in 1990. He and his ministers are engaged in "deep self-criticism," Mr PiÃ±era responded.

The unpopularity of the centre-right government is partly Mr PiÃ±era's own fault. Before becoming president, he was a successful businessman. He is an impetuous, headstrong workaholic, who is reluctant to delegate. As a result, he has become a lightning rod for all criticism of the government. His coalition partner, the Independent Democratic Union, the larger and more conservative of the two governing parties, is growing restless.

The protests have gone beyond predictable leftist agitation. The government seems surprised by the breadth of opposition to the proposed HidroAysen electricity scheme. The plan involves building five dams on two Patagonian rivers, flooding 5,900 hectares (14,600 acres) of nature reserves. Chile, with little oil and gas, faces an energy shortage, especially if the economy continues to grow by 6% a year. Officials point out that opponents of the dams have failed to propose a feasible

alternative. But many Chileans worry at the threat to part of their country's raw beauty. Some say Mr PiÃ±era gives more weight to the concerns of business than of the environment, and that he should have organised a national debate on energy policy before pushing ahead with HidroAysen.

But Mr PiÃ±era has no reason to despair. At an equivalent stage in her presidency, his predecessor, Michelle Bachelet, was similarly unpopular. When she left office three years later she had an approval rating of 84%. And respondents in the Adimark poll disliked the opposition, the centre-left Concertacion coalition, which ruled for two decades until last year, even more than the government.

Some commentators think the protests express a widespread sense that after two decades of democracy and steady economic growth, Chile remains a very unequal country. Some would like to change the electoral system bequeathed by General Pinochet, under which the two main coalitions are guaranteed almost all the seats in Congress. But since that is in neither side's interest, it would take many more marchers to achieve that. Perhaps the main lesson of the protests is that after a long convalescence from the trauma of political strife and dictatorship, Chile is becoming a normal country.

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Canada

The irrelevance of separatism

A more confident Quebec has other things to think about

CHARLES SIROIS, one of Canada's leading bankers, sees many things when he looks out over Montreal from his 38th-floor office: the densely packed buildings of Canada's oldest financial district, the broad sweep of the St Lawrence river in the distance, and a province that he thinks has grown tired of debating whether it should separate from the rest of Canada. Until recently a supporter of Quebec's ruling provincial Liberal party, Mr Sirois has reached across the French-speaking province's political divide to found a new movement with Francois Legault, a former minister of the separatist Parti Quebecois (PQ).

The aim of their Coalition pour l'avenir du Quebec (Coalition for the future of Quebec) is to persuade Quebeckers to set aside the province's central political question in order to concentrate on its more immediate problems of education, health care, the economy and preserving its distinct culture. This initiative strikes such a deep chord that were an election held today some polls indicate the Coalition would win a majority of seats even though it is not yet, and may never be, a formal party.

Quebec's status has blighted Canadian politics for almost half a century. As recently as 1995 a referendum on independence was lost by barely a percentage point. Two out of five Quebeckers continue to tell pollsters they want separation. Yet if not dead, there are many signs that separatism has slumped into a deep coma. Mr Legault, who is 54, quit politics in 2009 to return to the private sector. "If I go back into politics, it won't be to achieve the sovereignty of Quebec," he says. "I don't expect to work on the sovereignty of Quebec for the rest of my active life."

Others have reached the same conclusion. Last year, Lucien Bouchard, a former PQ premier, said sovereignty was unattainable. In 2005 he formed part of a group dubbed *les lucides* (the lucid ones) that issued a manifesto calling attention to many of the same socioeconomic issues that the Coalition has targeted.

But the most startling sign of change was the near-extinction in last month's federal election of the Bloc Quebecois, set up amid separatist fervour in 1991 to fight for provincial independence from within the federal parliament. The Bloc went into the election with 47 seats and came out with just four; in its stead, the New Democrats (NDP), a left-of-centre federalist party, captured 59 of the province's 75 seats.

Jack Layton, the NDP's leader, promised to make French the language of work in federal institutions in the province and to require justices of Canada's Supreme Court to be bilingual. Opponents dismissed these as cheap campaign shots, but they chimed with the mood in the province. Younger Quebeckers "are very much focused on language politics rather than sovereignty versus federalism," says Christian Bourque of Leger Marketing, a pollster. The Coalition has taken a similar position.

The rout of the Bloc has swiftly been followed by the implosion of the PQ, which only months ago seemed set for a return to office in Quebec City. Six of its provincial legislators have broken away to sit as independents; open warfare has broken out between supporters of Pauline Marois, the party's leader, who wants to soft-pedal independence, and those of Jacques Parizeau, one of her predecessors, who doesn't.

In part the separatist movement has been a victim of its own success. When it began, many among the French-speaking majority felt that they were bossed around by an English-speaking elite. But changes brought in when nationalists first took power in the province in the 1960s helped Quebeckers gain control of business. Subsequent legislation has ensured that French is the language of business and of education in the province.

The Coalition mirrors an earlier moderate breakaway from the PQ, Action democratique de Quebec, which grabbed 31% of the vote in a provincial election in 2007 only to fade swiftly. The continued splintering of the PQ will help Jean Charest, the unpopular Liberal premier who has led the provincial government since 2003. Mr Charest, whose political obituary has been written many times, might even call an early election, rather than wait until 2013.

But for the moment it is the Coalition that has captured the public's imagination. It plans to publish a manifesto by the end of the year. If any of the existing parties adopts its proposals, the movement will have achieved its aims, say the co-founders. If not, Mr Legault is prepared to form his own party to push the Coalition's platform. At that point, the Coalition will have to make clear its position on Canada's constitution, which Quebec has never signed. But the answer most Quebeckers seem to favour to that once-burning question is to ignore it.

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Thailand's general election

Lucky Yingluck

Even copying their opponent's policies has done the ruling party little good

WITH little more than a week to go before polling day on July 3rd, it is clear that the opposition Pheu Thai (PT) party will win more seats than any other in Thailand's 500-strong parliament. This will mark an extraordinary comeback for the unofficial leader of PT, Thaksin Shinawatra, a former prime minister ousted in a military coup in 2006 and now living in exile in Dubai as a fugitive from Thai justice. Some even predict that PT may win an outright majority, though a hung parliament looks more likely. But in Thai politics merely winning an election is not enough; whether PT gets to form a government is another matter entirely.

The surge of enthusiasm for PT owes a lot not only to Mr Thaksin's enduring popularity among Thailand's rural poor, but also to the dizzying rise of the official party leader, his younger sister Yingluck, who was unknown only a month or so ago. When Mr Thaksin picked her to lead PT into the election many dismissed it as a quixotic, even bizarre gesture. It turns out to have been a stroke of genius.

The 44-year-old businesswoman has never held or campaigned for political office before. Yet she behaves as if she has been doing it all her life and has completely wrong-footed her main opponent, Abhisit Vejjajiva, the prime minister and leader of the Democrat Party that heads the ruling coalition. At the start of the campaign the two rivals were just about even. It is mostly Ms Yingluck's bravura campaigning that has opened up the gap. Mr Thaksin described his younger sister as his "clone". In fact, she brings her own qualities and attributes to the campaign, drawing in people beyond the PT base.

A fresher face even than the relatively youthful 47-year-old Mr Abhisit, and a woman campaigning in the very male world of Thai politics, she has injected a buzz and excitement into the election. Her seasoned, pragmatic campaign managers have exploited her looks and easy-going nature to the full. She, for her part, has played the perfect candidate by sticking closely to her sound bites and smiling ceaselessly at the camera.

As to her policies (not that her adoring supporters care), she has promised to continue the populist economic programmes of her brother when he was prime minister from 2001 to 2006. She promises, for instance, to give free Tablet PCs to about 1m new schoolchildren and to raise the minimum wage. But, aware that triumph for Mr Thaksin's party will undoubtedly rile those (such as the army) who got rid of him in a 2006 coup, she has struck a conciliatory tone. She vows that there will no revenge for the coup, and that she won't rush into devising amnesties for Mr Thaksin. For all the enthusiasm of his "red shirt" supporters, he remains a divisive figure.

Even with the advantages of incumbency, the Democrat Party has floundered. Their rather bewildered campaign manager concedes that the timing of Ms Yingluck's candidature, pretty much on the day the campaign began, was brilliant. She stole the headlines and has never looked back-and a month is just long enough to remain an exciting novelty while avoiding serious scrutiny. Some mutter that she could yet have to answer to charges of perjury arising from the sale of Mr Thaksin's telecoms company five years ago, but that will have to wait until after July 3rd.

In contrast to the smiley-feely Ms Yingluck, Mr Abhisit and his deputy and finance minister, Korn Chatikavanij, are both Oxford-educated technocrats, less polished at working a crowd. Mr Abhisit has looked less stiff on the stump than in past elections, though it doesn't come naturally. One recent afternoon, he walked the length of a market in Bangkok, shaking hands, posing for photos with vendors and residents, a yellow garland draped around his powder-blue shirt and windbreaker. Supporters foisted gifts on him; cakes, flowers and the odd baby. He smiled-but it might as well have been a wince. Arriving at a community centre where former drug addicts had gathered on plastic chairs, he launched into a detailed analysis of why Mr Thaksin's hardline policies against dealers did not work. He lost the audience's attention.

It does not help that the Democrat Party has proposed a lot of similarly populist economic policies to PT's. In the scramble for votes, especially among Mr Thaksin's core constituency of poorer supporters, the Democrat Party-against its better instincts-has also made a lot of expensive promises. It is offering subsidies for rice farmers and its own version of a hike in the minimum wage. One academic commentator, Thitinan Pongsudhirak, has called this campaign the "race to the populist bottom". Mr Korn has costed PT's populism at a whopping 2.06 trillion baht ($68 billion) in the first year, but the Democrats aren't doing so badly either. These promises of largesse alienate their traditional supporters in business, nervous about having to pay for the new wages, and do Ms Yingluck no damage.

The minnows will decide

For all the focus on Mr Abhisit and Ms Yingluck, if neither wins an outright majority of seats, then it will (as usual) be Thailand's smaller parties that play a decisive role in a hung parliament. None has any ideology; they will simply haggle for ministerial posts and local pork.

Bhumjaithai, a vehicle for Newin Chidchob, a banned politician and former Thaksin henchman, could come third, perhaps with 40 or so seats. The party says it will stick with the Democrats, its current partners, and is leery of PT. Another party, Chart Thai Pattana (CTP), is courting both main parties and may well join PT in a flash. Other parties lack the numbers but could add some ballast, particularly if PT is nervous about fraud cases that might disqualify MPs. One tiny party is led by a retired general, Sondhi Boonyaratglin, leader of the coup in 2006, and so an unlikely ally for Thaksinites. But there are no permanent enemies in Thai politics.

And then there is Mr Thaksin's old foe, the powerful army. Besides staging the 2006 coup, it was instrumental behind the scenes in the formation of the present government. It has promised to stay in its barracks. But a close result and the ensuing horse-trading might tempt it to meddle again-especially if it looks as if Mr Thaksin is on his way back.

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Religious extremism in Indonesia

Under attack

The jailing of a jihadist leader still leaves plenty to worry about

Basyir grins and bears it

THE ordeal of a 22-year-old female Pentecostal trainee-pastor began on the evening of June 9th in Situbondo, a town in east Java. Aprilia Dyah Kusumaningrum was set upon by three men after leaving a church service. The details of what she then suffered are disputed. But she was abducted in a car, ending up hundreds of kilometres away. She managed to make her way home only after local farmers cobbled together a bit of money for her bus-fare.

Theophilus Bela, of the Jakarta Christian Communication Forum, an NGO, says the abductors, who wore *serban*, a type of turban favoured by Muslims, were Islamic radicals. He tells the story as an illustration of the sort of religious violence that has become all too common in Indonesia. This year has seen perhaps two dozen attacks on churches, mostly on Java, Indonesia's most populous island. And Islamist attacks are not aimed solely at the Christian minority in a country with the largest Muslim population in the world. In February an Islamist mob lynched some members of the small Ahmadiyah sect, regarded by some orthodox Muslims as apostates, killing four. Members of the Shia minority have also been victims of violence.

It is hardly surprising, given this sad (and very fresh) litany of religious intolerance, that most analysts of religion and politics in Indonesia have taken a sanguine view of the jailing on June 16th of the jihadist leader Abu Bakar Basyir. Widely thought to have been the spiritual leader of Jemaah Islamiah (JI), a South-East Asian offshoot of al-Qaeda, Mr Basyir was sentenced to 15 years in jail. He had been arrested twice before, but got off lightly. This time prosecutors were able to link him to the running of a terrorist training-camp in Aceh province. He faces further charges over an attack on a mosque in a police compound in April. So the 72-year-old may well die behind bars.

His sentencing was a boost for Indonesia's police and judiciary. But it was largely irrelevant to the worsening phenomenon of Islamic extremism that lies behind the assault on the young pastor in Situbondo. The authorities have a worrying record of tolerating thuggery by groups using Islamic orthodoxy as a pretext.

The police have been extremely busy of late rounding up terrorist suspects. Forty-nine have been arrested, and four shot, since March, 16 of them just a few days before Mr Basyir's conviction (for plotting to poison police officers' food with cyanide). Fifteen more were arrested for helping in the attack on the police mosque in April. This activity may testify to the zeal of Indonesia's anti-terrorist police, but it is also, argues Sydney Jones, an expert on Indonesian jihadism with the International Crisis Group, a think-tank, a worrying sign of how widespread the threat remains.

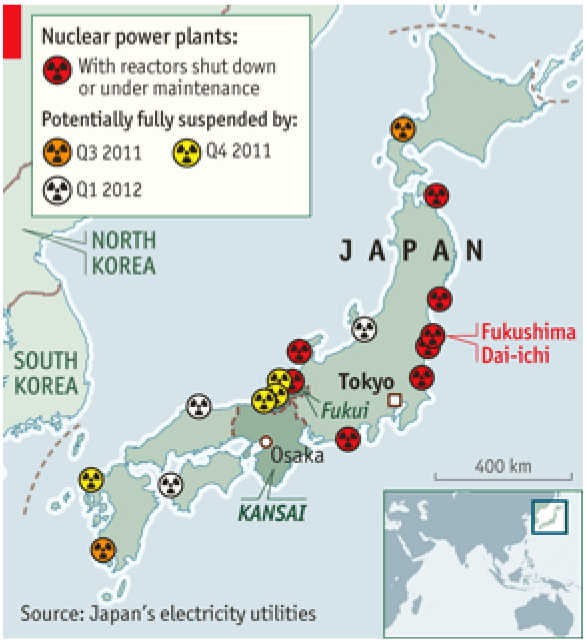
Probably only a few of these new suspects owe any direct allegiance to Mr Basyir, JI or any other established terrorist organisation. Even before his incarceration, Mr Basyir's influence had waned. Instead, Ms Jones argues, "violent action is increasingly the work of small groups formed out of religious study sessions." For that reason they will be harder to track.

Furthermore, although the police have got better at the kick-ass bit of fighting terrorism, moderate Muslims and Christians agree that the government lags far behind in tackling the underlying causes, such as the spread of Islamic extremism in schools and in society generally. In the past, the president, Susilo Bambang Yudhoyono, has seemed reticent about criticising religious extremism, perhaps for fear of alienating the Islamic parties in his coalition. But he has recently been talking up the state ideology of *pancasila*, which regards all the country's recognised religions as equal. That is welcome, but very few local authorities or schools actually implement the policy. Until that changes, the government's critics say, little else will.

Japan's energy crisis

A matter of trust

Nuclear fears-and their economic impact-spread far from Fukushima



THE Kansai region of western Japan has an economy as big as the Netherlands, is home to two electronics giants, Panasonic and Sharp, and has in its biggest city, Osaka, a fun-loving rival to Tokyo. When Japan was hit by the March 11th natural and nuclear disasters, Kansai thought it would do its bit for Japan by revving its economic engines. To its chagrin, however, it has found itself in a similar pickle to Tokyo.

Kansai drew no nuclear power from the stricken Fukushima Dai-ichi nuclear-power plant. But its regional monopoly, Kansai Electric Power (KEPCO), has asked clients to cut energy consumption by 15% at peak times between July and September. Citizens risk a sweat-soaked summer without air-conditioning. Tokyoites are bracing for something similar. Unlike theirs, however, Kansai's leaders are in open revolt.

The issue is trust, which has been wearing thin in Japan ever since the nuclear accident. The Union of Kansai Governments, a group headed by the seven prefectural governors, believes that energy savings of 5-10% are enough. The most outspoken governor, 41-year-old Toru Hashimoto of Osaka, reckons only households need to make cuts. Pointedly wearing a polo shirt, he met KEPCO's well-groomed president on June 21st and demanded that the utility publish daily assessments of the supply and demand of energy, rather than seeking an across-the-board cut. If a shortfall became imminent, people should switch off their air-conditioners and wear shirts like his, he says.

He appears to suspect that KEPCO is exaggerating the risk of power shortages to put pressure on local leaders to restart suspended nuclear plants. This is a national problem. At present 35 of Japan's 54 nuclear reactors are shut, mostly for routine safety inspections. Yet since March 11th local governments have refused to reopen them until there are credible safety assessments. It is conceivable that by next March all 54 could be out of action, since there are fresh inspections every 13 months (see map). That would in effect strip Japan of about 24% of its pre-March 11th power-generation capacity.

Kansai relies more on nuclear power than does anywhere else in the country. All of it is generated outside Kansai, in Fukui prefecture. On June 23rd a leading seismologist described one of Fukui's reactors, Tsuraga-1, as particularly dangerous because it is old and close to a fault line. However, business lobbies say it could be ruinous if the reactors do not reopen. The Kansai Institute for Social and Economic Research says a mere 5% drop in energy consumption this summer would wipe out the region's expected GDP growth of 0.5% in this fiscal year. In the country at large, the Japan Centre for Economic Research estimates that, without nuclear power, GDP in 2012 would be 1.6% lower than it would otherwise be.

Such forecasts might just be lobbying tactics. The Kansai Institute admits its biggest donor is KEPCO. Its affiliate, the Kansai Economic Federation, is chaired by the boss of KEPCO. The Japan Centre for Economic Research is heavily financed by a federation of electricity utilities, all but one of which use nuclear power.

Mr Hashimoto is openly anti-nuclear, which means he too has an axe to grind. At times he seems recklessly sanguine about the economic impact of abandoning nuclear power. He says that if Osaka can get through this summer without nuclear energy, it could do without it for good.

The problem is that the trust deficit extends to the national government, whose reputation as a nuclear regulator has been battered by Fukushima. Banri Kaieda, the economy minister whose office has responsibility for nuclear oversight, declares that most of the reactors are safe to reopen, but he has not revealed the grounds for making that judgment. Mr Hashimoto says this is back-to-front reasoning: the government should spell out the risks, not the safety assurances, and then let the public decide. So sour is the prevailing mood that this really might put a nail in the nuclear coffin.

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Repression in China

No melting mood

The timely release of a "tax evader"

AMID their most intense crackdown on dissent in several years, the Chinese authorities have given a rare hint of softening in the case of one prominent activist, Ai Weiwei. Late at night on June 22nd, looking thinner after nearly three months in detention, the bearded and still portly artist returned home. This, however, is unlikely to signal any let-up in China's efforts to silence critics.

Officially, Mr Ai is "on bail". China's state-owned news agency, Xinhua, said he had been freed because of his "good attitude in confessing his crimes as well as a chronic disease he suffers from" (he has diabetes and high blood pressure). Mr Ai had also "repeatedly" said he was willing to pay taxes he had allegedly evaded. Chinese police like to use accusations of economic crimes as a pretext to lock up dissidents. Mr Ai himself has refused to give details of his detention or comment on the charges, saying he was "on probation" and could not talk.

Mr Ai's detention aroused widespread criticism in the West. So it may not be a coincidence that China's prime minister, Wen Jiabao, was due to start a tour of Hungary, Britain and Germany two days later. China has occasionally released dissidents to smooth the way for important diplomatic exchanges.

But given China's current mood, Mr Ai's release was unexpected. Police had refused to say where he was being kept, despite insisting he was under "residential surveillance". His treatment testified to a new high-handedness in the handling of dissidents, several of whom have simply disappeared. Many observers believe this is related to the Communist Party's anxiety as it prepares for a sweeping change of its most senior leaders over the next couple of years. Mr Wen, for example, will retire in 2013.

Mr Ai may partly owe his freedom to his influence at home. He is the son of one of the Communist Party's most celebrated poets, Ai Qing. Mr Wen himself quoted the late Mr Ai's poetry at a press conference in 2007. He said, as few Chinese officials would dare to in today's political climate, that to make people happy, China must ensure their democratic rights: "You may ask: what do you mean by being happy? Let me quote a line from Ai Qing, a Chinese poet, 'Go and ask the thawing land, go and ask the thawing river'". Chinese dissidents see little sign yet of an end to the freeze.

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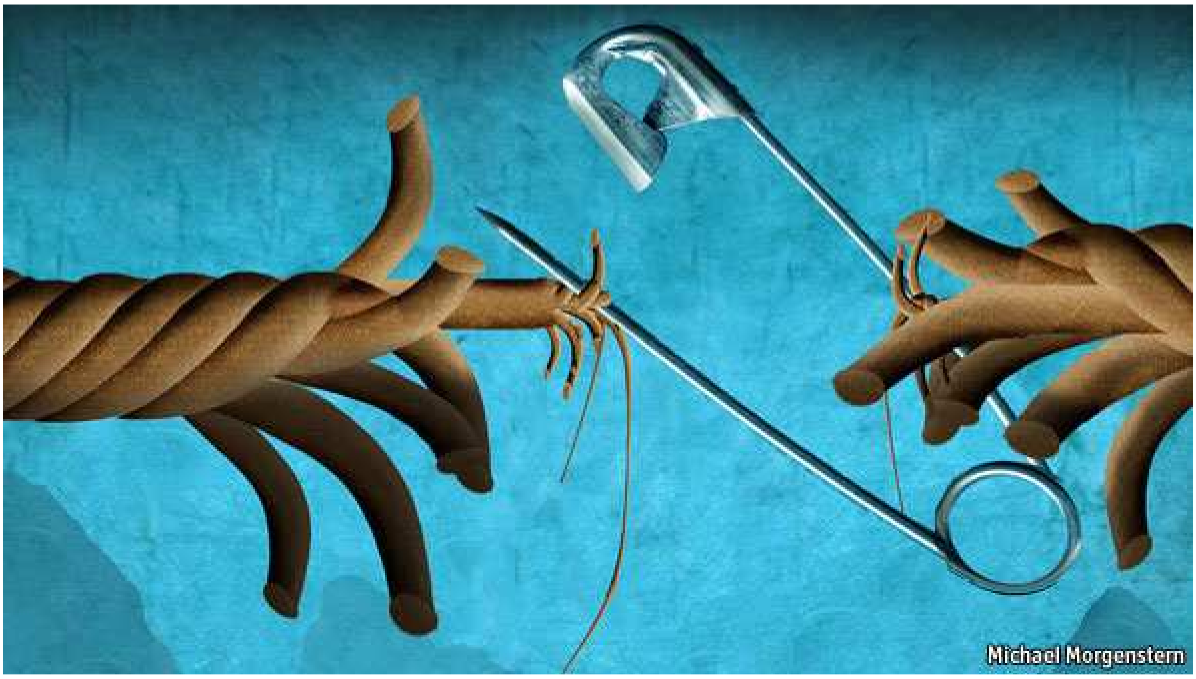
Banyan

Neither a picnic nor a Switzerland

The end of the surge in Afghanistan, and the beginning of a search for peace



FOREIGNERS have always struggled to exercise any sort of control over Afghanistan. And the war America and its allies embarked on there in 2001 has often seemed as endless and unwinnable as so many previous invasions. But the past few days have seen the American administration attempt to show that it can manage at least the narrative of the war. It wants to turn the story of a grim, inescapable quagmire into one of erratic but irreversible progress towards a resolution acceptable to all. It is a better story, but can it be a credible one?

Killing Osama bin Laden was a huge help. In a sense his death accomplished the primary mission that took America into Afghanistan. But he was killed in Pakistan and most of the 130,000 foreign troops in Afghanistan are not engaged in hunting down al-Qaeda remnants. They are there to stabilise Afghanistan. So when Barack Obama confirmed this week that America will begin drawing down its troops in July, he had to point to progress in Afghanistan itself as well as in killing leading terrorists.

His announcement fulfilled a promise made when he approved a "surge" of 30,000 additional troops in late 2009. Indeed, he said all the surge troops are to be back by September 2012. The plan is to leave the Afghan government responsible for its own security by 2014, through a beefed-up national army, supported by a much-diminished but still large foreign contingent.

Nobody expects that Afghanistan will be wholly at peace by then, nor that the Taliban insurgency will have been routed. So for the troops to leave with dignity there needs to be some semblance of a peace process. This week, America's defence secretary, Robert Gates, confirmed that America has been engaged in "very preliminary" talks with the Taliban. That requires some embellishment of the Taliban's image. That is tricky when they are the enemy. At America's urging, a United Nations sanctions committee has agreed to distinguish between the Taliban-a domestic political force as well as an armed insurgency-and al-Qaeda, perpetrator of global terrorism.

The obstacles in the way of reaching an accommodation with the Taliban are manifold. There is the oft-repeated cliche that "the Americans have the watches, but the Taliban have the time." Setting a timetable for withdrawal gives the Taliban reason to think that they can wait out the latest foreign power to try to bend Afghanistan to its will. And of course at the same time as pursuing "outreach", America is doing its high-tech damnedest to kill as many Taliban leaders as it can. In what one Western diplomat calls the Taliban's "*madrassa,* linear-thinking sort of way" this does not infuse talks with mutual trust.

Then there is the thorny question of which Taliban Mr Obama wants to reconcile. The insurgency is conventionally broken down into three main components: the "Quetta *shura*" of Mullah Omar, the leader of the former Taliban government, now holed up in Baluchistan in Pakistan; and two other forces, the Haqqani network and Hizb-e-Islami. But even this topology grossly oversimplifies. The Taliban, too diffuse even to be considered a "movement", range from bloodthirsty bandits and drug-lords to pacific tribal elders, representing the conservative social mores of the Pushtun, Afghanistan's largest ethnic group.

Ethnic kinship and a determination to see friends in power in Kabul make it unlikely that Pakistan will ever turn fully against the Taliban outfits it has nurtured. And, so long as it enjoys safe havens across the border, the insurgency will never be wholly defeated. But so long as the government in Kabul has the military and financial resources to survive-and America remains committed to ensuring that it will-some Taliban supporters will surely conclude that they have more to gain from an accommodation with it than from the resumption of full-scale civil war.

However, that accommodation is not straightforward. The settlement reached in Bonn in 2001 after the toppling of the Taliban was a "victors' peace", and needs changing. The president, Hamid Karzai, is a Pushtun. But his regime is widely seen, in the Pushtun-dominated south, as a corrupt interloper representing Persian-speaking Kabulis propped up by white foreigners. For their part, non-Pushtun northerners are hardly going to cheer a Taliban return. Last month Amrullah Saleh, a former spy chief who resigned last year in protest at the government's conciliatory approach to Pakistan and the Taliban, mustered more than 10,000 Afghans to join a rally in Kabul against "deal-making". Nobody is taking to the streets to demand that Mr Karzai welcome the Taliban back.

Hamstrung by Hamid

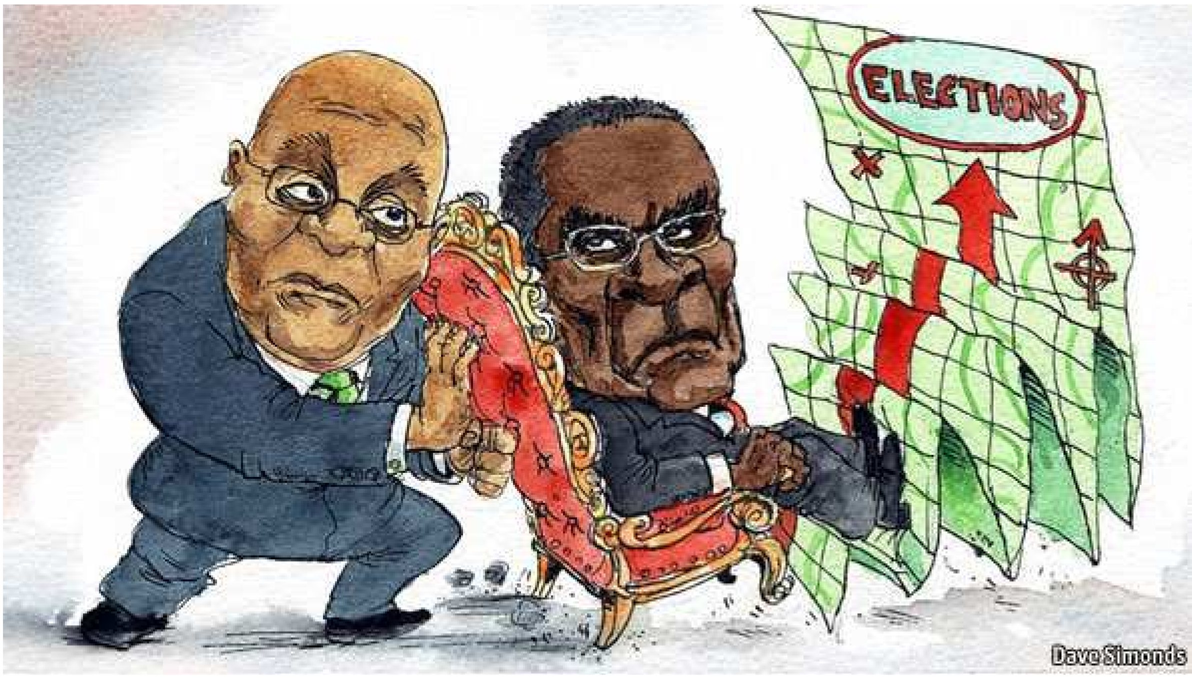
Mr Karzai himself is among the biggest obstacles that stand between America and a dignified withdrawal. That his supporters scandalously rigged the 2009 election which prolonged his rule was bad enough. But now, despite owing his office to the West's intervention in 2001, he has become among the loudest critics of its role in Afghanistan. In a splenetic recent speech to a conference of young people in Kabul, he told them that foreigners had come to Afghanistan "to pursue their own goals". "They use our country," he complained, accusing them both of taking away "100 times more profit from the country than they give it," and of behaving like a rich guest, who has "involved us in a picnic".

Without naming Mr Karzai, the outgoing American ambassador, Karl Eikenberry, responded fiercely, saying in a speech that, hearing this sort of outburst, Americans "grow weary of our effort here". They certainly do (see Lexington). But the risk for moderate Afghans is less that America cuts and runs, abandoning them to a bloody Taliban restoration, than that its criteria for what constitutes an acceptable settlement keep creeping lower. It has become a commonplace to acknowledge that a post-war Afghanistan will "not be Switzerland". But below Switzerland lies a huge range of possible outcomes, most of them bleak.

Zimbabwe's future

A new road map for Zimbabwe?

Robert Mugabe's neighbouring leaders may at last be turning against him



NOT since Morgan Tsvangirai entered a power-sharing government with President Robert Mugabe two-and-a-half years ago has the mood within his Movement for Democratic Change (MDC), formerly the main opposition party, been so upbeat. The Southern African Development Community (SADC), which guarantees the power-sharing pact, may at last be willing to tighten the screws on Zimbabwe's ageing despot. At a summit in Johannesburg earlier this month, the often feckless and invariably deferential 15-member regional club issued a report that condemned the dogged refusal of Zanu-PF, Mr Mugabe's party, to honour the pact. It also agreed to set out a "road map" for violence-free and fair elections to be held, probably some time next year.

Mr Mugabe has been left isolated, humiliated and fuming. He lobbied hard to get the report, drawn up by Jacob Zuma, South Africa's president and SADC's "facilitator" on Zimbabwe, rejected by his regional colleagues. Though the report did not mention him or his party by name, it was obvious who was being singled out. Lamenting the "continuous backtracking and lack of implementation" of the power-sharing pact, Mr Zuma said the situation in the country could no longer be tolerated. The anti-government uprisings in north Africa had shown the need to unblock the Zimbabwean impasse speedily and "in a way that will not just satisfy the SADC region but also that would be acceptable to the entire world."

Rejecting Mr Mugabe's call for fresh elections this year, Mr Zuma said a poll in the prevailing atmosphere of "violence, intimidation and fear" would lead the country back to the dreadful violence during the last elections three years ago or even to "a far worse situation". That is why clear conditions for a new poll, including outside observers and the unfettered access of all parties to print and broadcast media, were needed.

Negotiators from SADC and Zimbabwe's three main parties adopted a first draft on June 2nd. Despite furious opposition from Zanu-PF's leaders, who claimed that it was all a Western-backed plot to rig the elections and impose "regime

change", the negotiators have been told to draw up a final road map, along with timetables, ready for adoption at SADC's next summit, in August.

It is far from certain that Mr Mugabe will ever accept such a document, let alone stick to its conditions. "We will not brook any dictation from any source," he stormed when Mr Zuma's report (which has only just become public) was initially endorsed in March by a SADC "troika" that deals with politics and security. "We are a sovereign country. Even our neighbours cannot dictate to us." The facilitator's job, he said, was simply to facilitate dialogue. "He cannot prescribe anything. We prescribe what we do in accordance with our own laws." He now claims that the report was rejected at this month's full summit, pointing out that the final communique merely said it had been "noted" rather than "endorsed". SADC officials say this means the same thing and that it has been annexed to the summit's official report.

The MDC has lost quite a lot of support because of its patchy performance in the unity government. All the same, if free and fair elections were held, the odds would favour an MDC victory. But would Mr Mugabe ever accept losing power? The heads of the security forces, which fall under his direct control, have sworn never to accept Mr Tsvangirai as president. Some watchers fear that Zimbabwe could become like Cote d'Ivoire, where an incumbent president clung to power for many months after his election defeat, plunging his country into civil conflict. Others hope that Mr Mugabe, now 87 and in failing health, might, along with his generals, be persuaded to retire peacefully if all were guaranteed immunity from prosecution, the removal of targeted sanctions by the West, and the retention of their riches.

Many Zimbabweans, grown sceptical over the years, shake their heads in disbelief. In power since independence 31 years ago, Mr Mugabe seems to regard himself as a kind of monarch who must reign until his death. Not so long ago, he could have counted on the support of SADC leaders, many of them fellow veterans of anti-colonial struggles. But they are being replaced by a less respectful younger generation with more awareness of the link between good governance and their countries' prosperity. SADC's leaders, especially its younger ones, are increasingly loth to see their region dragged down by an ageing autocrat. South Africa, already home to more than 1m Zimbabwean refugees, does not want to suffer yet another influx. Mr Zuma may at last really mean to get tough with his recalcitrant neighbour to the north.

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Syria's turmoil

Wooing the middle

The president is belatedly trying to convince his people that he means well

A SWATHE of undecided Syrians in the middle ground are being wooed both by protesters who want to bring President Bashar Assad down and by purported reformers in the regime who want to prop him up. On June 20th Mr Assad made a bid for support with his third public speech since the crisis started three months ago, his first in two months. It was not a success. The protests-and the deaths-show no sign of letting up.

Mr Assad acknowledged that some of the protesters were peaceful, offered a "national dialogue", promised yet again to enact reforms and talked of "making an amnesty more comprehensive". But he also made a string of fanciful claims that alienated sceptics all the more. He said he cherished "the love...of those who represent most of Syria's people." The unrest, he said, was the result of a conspiracy carried out by criminals and extremists that was spreading like a "germ".

On a more emollient note, he pledged to create a committee to look at ways of amending the constitution. He promised a law to regulate political parties, but made no mention of the role of his ruling Baath party as the sole arbiter of politics and social life. A new election, he said, would be held in August, but he offered no indication that it would be a more open affair than usual.

He acknowledged that both civilians and soldiers had died as a result of the unrest, but he did not concede that his security services had been mainly to blame. At least 1,400 Syrians are reckoned to have died so far; some say several hundred members of the security forces have also been killed. "We were surprised that [the protesters] have modern four-wheel-drive vehicles on which they had installed sophisticated weapons capable of dealing with helicopters," the president claimed, with no independent evidence.

He called for Syrians who have fled to Turkey, now numbering more than 10,000, to come home. "We cannot talk about normal life and economic life while there are people who have left their towns and villages," he said. There would be no revenge, he promised, yet arrests and shootings were being reported even as he spoke.

Meanwhile, the opposition, which dismissed Mr Assad's speech out of hand, is trying to draw the silent majority into its movement. Aware that the security forces' violence is deterring many from taking to the streets, it is finding other ways, especially economic, of squeezing the regime. People are being urged to stay at home on Thursday evenings at the end of the working week, when the streets usually bustle. The opposition is encouraging various expressions of dissent. People in Douma, a suburb of Damascus, are closing accounts at state-owned banks. In Damascus and Homs, Syria's third city, lists of local informants are being passed around anonymously. People in the port of Latakia are not paying bills and taxes. The once docile middle, weighing up options as the unrest persists, is no longer finding it easy to be neutral. Although wary of the protests to begin with, many middle-of-the-road Syrians have turned against the regime thanks to the ferocity of its repression.

Both sides claim to promote a democratic future. Even diehard backers of the regime, who wave flags and posters exalting Mr Assad at street rallies, now talk of reform. Each side accuses the other of stoking sectarian tension. The opposition blames the regime for arming gangs of Alawites, the Muslim sect to which the Assad family belongs. Predominantly Sunni demonstrators supporting the protesters wave Christian crosses and shout that Sunnis, Alawites and Christians are one.

Those in the middle are wary, not just because they fear violence. Hounded as it is by the regime, the opposition has yet to reassure ordinary Syrians of their credentials as future rulers. Various groups within the opposition are trying to unite in order to present themselves to the undecided as a credible alternative. "Co-ordination committees" have sprung up everywhere and have proved effective. But no strong figure has emerged as an overall leader.

Leading lights in the regime, on the other hand, are well-known, and almost universally reviled. Some, it seems, may now be ditched. On June 16th Rami Makhlouf, a presidential cousin often said to be the richest man in the country, declared that he would step back from his business empire, which spans oil, telecoms and property, to devote his time and money to charity. Few regard Mr Makhlouf's move as sincere. He is the family banker of the Assads, who need cash more than ever, as they fight for survival and contemplate a possible future in exile.

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The Bedouin of Sinai

Free but dangerous

Since Egypt's revolution, the Bedouin of Sinai have been able to do as they like

HUNKERED inside his fortified compound, North Sinai's governor, Abdel Wahhab al-Mabrouk, a military man, plans his counter-attack against the peninsula's rebellious Bedouin. Since the Egyptian uprising five months ago, they have thrown off the yoke of Egypt's police and are determined to keep it that way. "We'll kill them if they return," says a Bedouin sheikh. General Mabrouk has recently repainted one of four police stations in his provincial capital, el-Arish, which the Bedouin torched. Plans for restoring another are in hand. But on the streets outside the governor's building, uniformed police venture out only under an army escort.

The chaos may be the governor's best ally. Hospitals are crowded with the victims of tribal vendettas. Notices tied to lamp-posts record the names of women who have disappeared. Traders load their guns before setting off to do business, for fear of highwaymen. In the early hours of June 22nd two Egyptian soldiers were shot dead by masked gunmen in a main street of el-Arish. If such lawlessness continues, hopes an adviser to the governor, everyone will be begging for the police to come back and restore order.

Such hopes are, for the time being, forlorn. The Bedouin of Sinai loathe the old order. Talk to an adult male Bedou in North Sinai, and the chances are he will tell you he has been in prison, sometimes in solitary confinement in a cell too small to sit down in. For years Egyptian bureaucrats from the Nile Valley have refused to let the Bedouin register their land. Checkpoints dotting Sinai's rocky wastelands prevented the Bedouin from reaching their area's main cash-cows: the peninsula's tourist resorts, its oil installations and its giant cement factory. The government buildings that the Bedouin ransacked during the revolution are still littered with security files.

Most Bedouin leaders now prefer to rely on their own people to keep order. For decades, outsiders have manipulated their hierarchies and handpicked their sheikhs; now they are selecting their own. Control over smuggling routes linking Africa to Asia has provided them with enough guns and cash to keep the governor and his heavies away. A businessman robbed of $250,000 found it more sensible to appeal to Bedouin leaders than to the local courts, bereft of police to enforce rulings. "We can't really arrest anyone any more," moans the hapless governor.

Few Bedouin say they want to rid Sinai of Egyptian rule altogether, though the more wistful wonder whether Western powers might yet set up a Bedouin dynasty in Sinai as they did with the House of Saud in the Arabian peninsula. The more pragmatic Bedouin want a new contract with the state, including a degree of local autonomy, access to government and army jobs that have long been denied to them, and an amnesty from the sentences passed on them, often in absentia.

The governor has met tribal leaders and freed a few hundred prisoners. Egypt's justice ministry has signalled its readiness to release others who have served half their terms. Egypt's post-revolutionary prime minister, Essam Sharaf, has even paid el-Arish a visit, the first holder of his post to do so for years. But Bedouin leaders damned it as a cheap photo opportunity while, away from the cameras, Egyptian generals seemed intent on reviving the old order. "We're not in the business of legitimising smugglers, terrorists, drug barons and outlaws," says an intelligence officer.

In frustration, some Bedouin have resorted to sabotage. Within hours of Mr Sharaf's departure, a bomb blew up an unguarded pipeline that supplies Israel and Jordan with gas. They may yet attack South Sinai's oil installations and tourist resorts, and perhaps the Egyptian "guests"-workers whom the government settled on Bedouin territory in an effort to cement the state's grip. Attacks on cars with Nile Valley licence-plates are getting more frequent. The head of a women's association in Nakhl, an isolated Sinai town, fled back to the main bit of Egypt after 30 years. Bedouin protesters recently cut the road, albeit briefly, between Cairo and the tourist resort of Sharm el-Sheikh.

The governor denies reports that the vacuum in Sinai's rocky land, which has around 400,000 inhabitants, has been filled by 400 al-Qaeda men. But he accuses Hamas, the Palestinian Islamist movement, and Hizbullah, the Shia party-cum-militia that holds sway in southern Lebanon, of spotting a chance to stir up trouble. He adds that Salafist groups, who follow the puritanical Saudi model of Islam, have flourished since Hosni Mubarak's fall. A bomb recently destroyed the walls of Sinai's main Sufi shrine, but the dome miraculously dropped intact over the tomb.

Seeing threats in every corner, the governor has turned to the secret police, who have survived the uprising remarkably unscathed. By warning that the chaos may spill across the eastern border, he has persuaded Israel to allow 3,000 Egyptian troops into eastern Sinai, which, under the Camp David accords of 1978 that provided for Israel's withdrawal, is a demilitarised zone. Egyptian military vehicles now proliferate, though Egyptian soldiers have taken a hands-off approach to the Bedouin for fear of being dragged into a domestic squabble with them. The governor toys with the idea of a heavier crackdown, but it is plain that only a political agreement has a chance of restoring calm and preventing the pesky Bedouin from soliciting outside support, which would make Sinai even more dangerous.

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Iran's bold economic reform

Economic jihad

Iran has undertaken reforms that other governments in the region should envy

GOOD news from Iran is rare, and the IMF is seldom a font of happy tidings about anything. So when a mission from the Fund cheered the Islamic Republic's economy earlier this month, heaping praise on the policies of its ruthless government, eyebrows spiked upwards as in a comic scene in a Persian miniature. The shock was even sharper given that the IMF, whose biggest shareholder happens to be the Great Satan, America, is a pillar of global capitalism, a system that Iran's maverick president, Mahmoud Ahmadinejad, gleefully lambasts as evil.

Yet the IMF's upbeat pronouncement, in a brief press release (a fuller report is forthcoming) following annual consultations in Tehran, has some justification. This is not because Iran's economy is performing brilliantly. Whereas other big oil exporters have boomed on the back of high prices, Iran has grown sluggishly, nudging upwards only last year to 3.5%. That is not enough to dent a rising unemployment rate, which is now close to 15%.

The reason for the praise is Iran's exemplary execution of a task dear to the IMF's heart: structural reform. The Islamic Republic describes things differently. Speaking on the occasion of Nowruz, the Iranian new year in March, the supreme leader, Ayatollah Ali Khamenei, declared this to be the "year of economic *jihad*". Whatever its name, the sweeping reform of a ruinous, three-decade-old system of state subsidies that Iran began last December seems to be radically reshaping the country's economy for the better.

Not only has it relieved the government of a huge financial burden. It has slashed local energy demand, reducing chronic pollution and leaving more oil for export. It has dramatically raised disposable incomes for the poorest without placing extra burdens on the rich, spreading social equity while boosting consumption and bolstering the banking system. In future, Iran's subsidy reform may even be seen as a model for top-down social change, not unlike successful schemes pioneered by Mexico and Brazil. But so far Iran's scheme carries no conditions.

Until December, economists estimated the annual cost of subsidies on food, fuel and electricity at $60 billion-100 billion, a quarter of Iran's GDP and equal to or greater than the value of annual energy exports. Most of this burden was carried as an implicit subsidy to domestic energy consumers, with the price of diesel fuel, for example, set at the equivalent of two American cents a litre, and petrol selling for less than bottled water. The predictable results were soaring energy consumption, waste, smuggling, pollution, market distortion and inexorably rising bills for the state.

Iranian governments have long grappled with this problem. Mr Ahmadinejad's liberal-leaning predecessor, Muhammad Khatami, was stymied by a squeamish, conservative parliament. Mehdi Karoubi, a presidential candidate in 2005 and 2009, suggested tying cash handouts to reduced subsidies. Rivals dismissed this as an electoral ploy; Mr Karoubi, a leader of the opposition Green Movement, has since been hounded out of politics. Ironically, it may have been international

sanctions, intended to punish Iran for its suspect nuclear programme, that at last persuaded its opponents of the need to scrap subsidies. Lacking the refining capacity to meet domestic demand, Iran found itself vulnerable to a sudden cut-off in petrol imports.

This long debate helped to prepare the public and let the government plan carefully. Accepting the need to compensate consumers for raising prices closer to world levels, Mr Ahmadinejad at first proposed a monthly cash transfer aimed at poor families. When defining the poor proved tricky, this was dropped in favour of blanket transfers to any family that applied for them. Some 19m families, 90% of Iran's population, have done so, setting up bank accounts to receive monthly payments based on numbers of family members. The government then set up a fund to administer receipts from the higher-priced goods, demarcating 50% to go towards families, 30% to help businesses affected by price rises and 20% to meet the state's own added costs.

The government cleverly doled out two months' worth of family cash transfers, amounting to some $90 per person, before unleashing its shock. When the first tranche of price rises hit, quadrupling the cost of some kinds of bread and shooting diesel prices up by 2,000%, among other things, there was barely a peep from the public. Iranians have rapidly got used both to paying a lot more for some things and to having more money to spend as they wish. A family of five now pockets monthly sums close to Iran's minimum wage, enough to pull a big proportion of the 10% of Iranians who live on less than $2 a day above that bar. Yet tight controls on the money supply have kept inflationary pressure lower than feared. By some counts it has already fallen from an annualised 20% in March to 14% in May. With government finances now in better shape, that may drop still further, and quickly.

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Saudi Arabia

The brrrm of dissent

Even the most conservative of monarchies is facing change

THE Saudi way of life is under threat. On every border of the kingdom, ungrateful subjects have turned against their rulers. A powerful ally and shield for 60 years, America, has forsaken friendship and applauded these uprisings, while the

Shia devils of Iran plot intrigue everywhere. Trouble brews in the kingdom, too. King Abdullah is 89 or so and weak with age. Crown Prince Sultan, his anointed successor, is 87 and ailing. The next in line, Prince Nayef, the feared interior minister, is 78 and badly diabetic. The young grow restless and impertinent. Some sign petitions calling for rights and a constitution. Others exchange scurrilous messages by computer and telephone. Even women (see above) show no respect, illegally-and immodestly-driving cars down streets.

Such, at any rate, is the view of crusty Saudi conservatives. The world's most absolute monarchy looks anomalous not only to foreign infidels but also to fellow Arabs and even to its own people. But is the kingdom really in danger of being swamped?

No, say most observers, at least not soon. It is a big country. Most Saudis are a lot better off than most Egyptians, Syrians or Yemenis. The money showered on them by the state still buys individual complacency and the complicity of big business and big religion. The kingdom's strongest religious trend, the *Sahwa* (Awakening), mixes traditional religious conservatism with a reformist political streak inspired by the Muslim Brothers. It has the organisational reach to make trouble. But its figureheads remain pampered by the ruling family-and loyal to it. Without their blessing, no protest movement is likely to gain traction.

The money shows no sign of drying up. Confident of its ability to move markets, Saudi Arabia may ramp up oil production by 500,000 barrels a day (b/d), snubbing calls by other OPEC members to curb supplies and keep prices high. Investment in new oilfields and infrastructure suggest that the Saudis can sustain production at a hefty 10m b/d-worth around $1 billion at current prices-for some time to come.

Yet subtle changes are afoot. An increasingly irreverent, subversive tone infuses chat in the thriving Saudi ether via text messages, Twitter and Facebook. This reveals a growing gap between the elderly princes and an increasingly cosmopolitan populace.

On June 17th only a few score women actually got behind the wheel to protest against the unique Saudi ban on female drivers. By and large, police shied away from intervening, emboldening more women to join the movement. The Saudi way of life may be about to shift.

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Italian politics

Still in league

The Northern League is growing restive inside Italy's government. This poses a new problem for Silvio Berlusconi

SELDOM has Harold Wilson's quip about a week being a long time in politics seemed more apt. A week ago Silvio Berlusconi, Italy's prime minister, was in a fix. His candidates had been decisively rejected in mayoral elections in Milan and Naples. More than half the voters had ignored his advice to abstain in referendums that negated some key parts of his government's legislative programme. The opposition was baying for his resignation.

A week later and his adversaries are on the defensive. Mr Berlusconi's government won a confidence vote in the lower house of parliament, by 317 votes to 293; the first time he had obtained an outright majority since the summer of 2010, when his longstanding ally, Gianfranco Fini, split, taking several deputies with him. The opposition, fearing more defeats, twice shrank from tabling further confidence motions. In speeches to parliament, Mr Berlusconi exuded resolution. There was no alternative to his coalition with the Northern League, he said, and it was his "firm intention" to carry on to the next election, due in 2013.

What brought about the change? The most important event took place in a field north of Milan. The *pratone*, or big meadow, outside the town of Pontida is where the Northern League meets every year amid a forest of flags emblazoned with its favoured symbols, the cross of St George and a green and white "alpine sun". This year the gathering was particularly significant because the League's charismatic founder and leader, Umberto Bossi, was expected to lay down terms for continuing in government.

The League's 59 deputies and 26 senators wield the power of life and death over Mr Berlusconi's government. What if they were to give him the thumbs down? The temptation is there: the prime minister's approval rating has dipped below 30 and the League is suffering from contagion. Yet for this very reason the result of toppling Mr Berlusconi, as Mr Bossi reminded the crowd at Pontida, would probably be to let in the left. Since the League's leader has steered his party so far to the right, it would have enormous difficulty in forging any alliance with the opposition-and that is assuming the party would win enough seats to be of any use.

Yet Mr Bossi duly made his demands. He wants Italy to stop bombing Libya to stem the flow of refugees across the Mediterranean. He wants up to four ministries transferred from Rome to the north. And, most controversially, he wants tax cuts at a time when Mr Berlusconi's hard-pressed finance minister, Giulio Tremonti, is struggling to reduce the budget deficit to ensure Italy does not go the same way as Greece. But Mr Bossi's demands were not conditions; he made clear that he would stand by Mr Berlusconi for the next two years.

The effects were not long in coming. Italy's president, Giorgio Napolitano, stamped on any notion that Italy might renege on its NATO commitments, and the League's negotiators failed to secure any ministries (although they did win a promise of some representative offices).

What about taxes? This is of wider European concern. Italy is potentially at risk of being engulfed by the euro crisis, as Jean-Claude Juncker, head of the euro group of finance ministers, has pointed out. Its public debt will exceed 120% of GDP this year. A week ago Moody's said it was considering downgrading Italy's credit rating. Far from contemplating tax cuts, Mr Tremonti is reportedly working on a package of measures to trim the deficit by another euro40 billion ($58 billion).

In his speeches to parliament, Mr Berlusconi said a tax-reform bill that he plans to unveil before the summer recess would "not open holes in the budget". But he also said it would cut the number of income-tax rates to three, and that they would all be lower. It would seem possible to square the circle only with tax rises elsewhere or more spending cuts, in a society where the pain of Mr Tremonti's earlier austerity measures is starting to be felt. On June 22nd there were clashes between police and teachers outside parliament.

Nor are social tensions Mr Berlusconi's only problem. A deep rift has opened within the Northern League between a so-called "magic circle" around Mr Bossi and a group that looks increasingly to Roberto Maroni, the interior minister, seen by some as an alternative to Mr Berlusconi. Discord in the League risks destabilising the government, or even breaking it apart.

For the moment, though, the durable Mr Berlusconi looks safe. He would doubtless approve of another of Harold Wilson's aphorisms. "I know what's going on," he told a rally in 1969 as he faced a similar crisis. "I'm going on."

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Poland and the European Union

Presidential ambitions

What the Poles have in mind for the EU

POLAND takes over the rotating presidency of the European Union for the first time on July 1st. Since the Lisbon treaty created a permanent president of the European Council the role has become less important. Yet the Poles have clear goals for their six months in charge.

Political stability will help. A recent poll gave the ruling centrist Civic Platform, led by the prime minister, Donald Tusk, 49% support against only 27% for Jaroslaw Kaczynski's conservative Law and Justice party. The economy is doing well. A general election in October may prove a distraction but it is unlikely to produce a change of government.

The EU presidency is being co-ordinated by the Europe minister, Mikolaj Dowgielewicz, a level-headed former spokesman at the European Commission. He is a career civil servant rather than a politician, which may help his relations with Mr Tusk. He commands a legion of young administrators, many of whom cut their teeth preparing for Poland's EU entry in 2004. The foreign minister, Radek Sikorski, will cut a dash on the world stage. And the British-born finance minister, Jacek Rostowski, can tell his counterparts how Poland, uniquely in the EU, managed to avoid recession in the financial crisis.

As much as three years ago, some of Warsaw's finest political brains were invited to contribute ideas for the presidency. Experts such as Pawel Swieboda, a former bureaucrat and now head of DemosEuropa, a think-tank, have identified the best and worst practices in past presidencies (Sweden's 2009 stint is seen as an exemplar, whereas Spain and Hungary, the current president, are said to have stumbled).

Holding the presidency will not stop the Poles fighting their corner. European competitiveness, they argue, cannot be secured just by cutting public spending. So they will want to promote a bigger EU budget for 2014-20 ahead of European

Commission proposals on June 29th. This will see them clash with Germany, France and Britain. This week Poland showed its teeth by vetoing moves to set a higher target for cutting EU carbon-dioxide emissions by 2020.

A second focus will be on European security. This has implications for relations with Russia. The Poles will put external energy policy on the agenda, focusing attention on Europe's dependence on Russian gas. Third, although Poland accepts that the Arab world now needs more attention-there is talk of a "southern neighbourhood" conference in December-it does not want the east to be forgotten. Expect work towards free-trade deals with countries in the EU's "eastern partnership" (Ukraine, Belarus and Moldova), plus attempts to make progress on enlargement.

The biggest legacy could be at home. Janos Martonyi, Hungary's foreign minister, calls his country's presidency a "maturity test". Similarly, Mr Dowgielewicz says, "Poland is now a normal modern democracy...and during the presidency that's the main thing we want to show the world."

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Nagorno-Karabakh's future

Caucasian questions

Some progress is being made, but many obstacles to peace remain

THE Soviet Union had three years left when rumbles hinting at its imminent collapse began to reverberate in the Caucasus. In 1988 leaders of Nagorno-Karabakh, a territory populated mainly by ethnic Armenians, demanded a transfer from Soviet Azerbaijan to Soviet Armenia. The Kremlin refused and a nasty war between Azeris and Armenians followed. As Thomas de Waal, an author on the Caucasus, writes, "it was the first stone in an avalanche that swept away the entire multinational construction of the Soviet Union." Some 20,000 people died in the war and over a million became refugees. Armenia won, gaining control over seven Azerbaijani regions next to Karabakh. A ceasefire came in 1994. Pipelines sprang up to ship oil and gas from Azerbaijan. Karabakh has gained some features of a state, but is the most combustive spot in the region.

Worryingly, Azerbaijan has poured energy revenues into its army-it spends $3 billion a year (5% of GDP). It makes menacing noises about reconquest. A new war would risk Azerbaijan's petro-wealth, but irrational behaviour is all too common in the Caucasus. A renewed conflict in a region that includes Turkey, Iran, Russia and Georgia is the stuff of nightmares.

Russia's president, Dmitry Medvedev, is the latest mediator. This weekend he will sit with his counterparts, Azerbaijan's Ilham Aliev and Armenia's Serzh Sargsyan, in the Russian city of Kazan to cajole them into accepting some basic principles first drafted in 2007. The idea is that Armenia should withdraw from Azerbaijani regions outside Karabakh and that the disputed territory should win "interim status", giving it some international legitimacy but falling short of full independence.

Mr Medvedev has invested time and effort in what will be his fifth trilateral meeting. Yet many experts who have watched these peace talks fail repeatedly remain sceptical. The two countries' semi-authoritarian leaders seem to prefer process to results and have done nothing to prepare people for peace. They may negotiate compromises in private, but they make fiery "no surrender" speeches in public.

There are doubts over Russia's motives. A benevolent explanation is that it has leverage over its ally, Armenia. Helping to resolve a complex conflict would win Mr Medvedev kudos. Grigory Shvedov, editor of Caucasian Knot, an online news agency, argues that Russia's strategic goal is to increase its political and economic influence in the Caucasus. Dominating negotiations, he says, may be more important than a solution that increases Turkey's influence.

Turkey would indeed benefit from a peace deal, but its sway over Azerbaijan is limited despite its big Azeri population. In a typical case of tail wagging dog, says Mr de Waal, Azerbaijan sabotaged moves to reopen the border between Turkey and Armenia in 2009. Yet he sees Mr Medvedev's initiative as the best chance for peace. The Armenians are signalling that they accept the draft. Azerbaijan has not rejected it but has not hinted at its agreement either.

The Americans and French, the other two mediating powers with Russia, are increasing the pressure. At the recent G8 summit in France, all three presidents stated that "further delay would only call into question the commitment of the sides to reach an agreement." If the two leaders agree in Kazan, it will be a big step, even if it leaves room for new disputes. Were Armenia to withdraw from its "security zone", the question arises of who would replace it. Russia may hope its role would give it an edge for providing peacekeepers, but that may not appeal after the August 2008 war in Georgia. Any notion of involving NATO troops would be fiercely resisted by Russia and Iran. One thing is certain: making peace in Nagorno-Karabakh requires the skill of walking over a minefield.

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France's government

Les quangos

The French have an unusually large number of pointless committees

THE university was cross because it was paying a lecturer who had not taught a single class all year. Absurd, retorted the lecturer, Luc Ferry, a philosopher and former education minister. He could not teach because he was on secondment to the Council for the Analysis of Society, a 32-member quango reporting to the prime minister. Besides, he added, "security reasons" made it hard for him to teach: a few years ago he could not get into a lecture hall because trade unionists were waiting outside with baseball bats. This month, as the row escalated, the prime minister's office said it would reimburse the university. The philosopher will stay on the council.

Mr Ferry dismissed the fuss as "totally grotesque", and denied that he had a "fake job". His council has a smallish budget, most of its members are unpaid and it produces reports. It is not to be confused with the nine-member Council for Employment, Income and Social Cohesion, nor the 51-member Employment Policy Council, and certainly not the 36-strong Council for Economic Analysis, which in turn has nothing to do with the 36-strong High Council for the Social Economy. One virtue of the Ferry affair is that it has exposed the messy tangle of quangos and commissions in France, many of which do little.

According to a little-publicised appendix to the 2011 budget, France has no fewer than 697 such commissions. Unlike statutory quangos, such as the anti-discrimination authority or the competition commission, these bodies mostly give advice. Some are self-explanatory, such as the Commission for Compensation for Damage by Wild Animals. Others, such as the Committee of Statistical Confidentiality, or the Strategic Committee for Intensive Calculation, are less so. France has commissions for noise, for the air, for water, for cold, for the polar regions, for rubbish and more. There are at least 13 commissions for inventing new French words or phrases. Charged with translating "breaking news" last year, one came up with the snappy *information de derniere minute*.

Some commissions do genuinely valuable work. The Pensions Advisory Council produces first-rate studies on the future financing of public pensions, which successive governments have used to promote reform. Others are less obviously useful. In 2009, the most recent year audited, the 31-member Cultural Council for the Union for the Mediterranean met twice. The National Committee for the French Initiative on Coral Reefs convened once. And the Council for Employment, Income and Social Cohesion, with an operating budget of euro351,000 ($505,000), did not meet at all.

"It is all totally opaque," argues Richard Mallie, an anti-quango deputy from the ruling UMP party. The commissions do not break down their budgets, and provide no information on hours spent or salaries paid. Although the government has abolished some of the most pointless, new ones keep cropping up. "Whenever there is a difficulty," says Mr Mallie, "we just create committees." In the 1960s Charles de Gaulle deplored the French tendency to set up a committee to work out what to think about anything. Half a century on, what would he have made of putting a philosopher in charge of one?

Drugs in the Netherlands

Closed shops

Why tourists in the Netherlands may have to stop smoking pot

Not everybody must get stoned

THE myth of Dutch tolerance may have faded in recent years, but the country still cherishes its social liberalism. Prostitution is legal, soft drugs are available to locals and foreign tourists alike, and the Netherlands prides itself on blazing the trail for gay marriage. But one of these traditions may be on the way out. In a rolling process, Dutch "coffee shops", where cannabis is freely sold for private consumption, could soon become closed clubs.

New government rules may force some 660 coffee shops that now sell cannabis over the counter to become members-only clubs with strict registration procedures, accessible only to Dutch residents. The government says the new policy is a bid to curb the "nuisance" of drug tourists and to fight organised crime. The measures will first be introduced in southern provinces that have most cannabis tourists. The government hopes to anchor the guidelines in a change of official policy to be debated in parliament in September.

According to Derrick Bergman, head of VOC, a lobby group that fights for the legalisation of marijuana, approval of the guidelines could mean the "end of the coffee shop as we know it." This will affect more than the country's desirability as a destination for backpackers or the turnover of a cannabis market worth hundreds of millions of euros. Mr Bergman fears the emergence of a new criminality, such as illegal trade in membership passes or street dealing, which could increase exposure to hard drugs.

The guidelines may not survive a legal challenge for discrimination. A potentially precedent-setting case was initiated by a coffee-shop owner from Maastricht, a southern Dutch city, against an earlier decision by the city's mayor to impose a membership scheme for residents only. After wrangling in Dutch and EU courts (which allowed an apparent breach of the single market on health grounds), the case is now being considered by the Council of State, the highest Dutch appeal body. The council's decision will affect the legality of the planned new coffee-shop regime.

The Dutch government is led by liberals and backed by a far-right party that claims Islam is incompatible with liberal democratic values. It recently tried (and failed) to regulate prostitution through a system of passes. The nature of Dutch liberalism is certainly changing.

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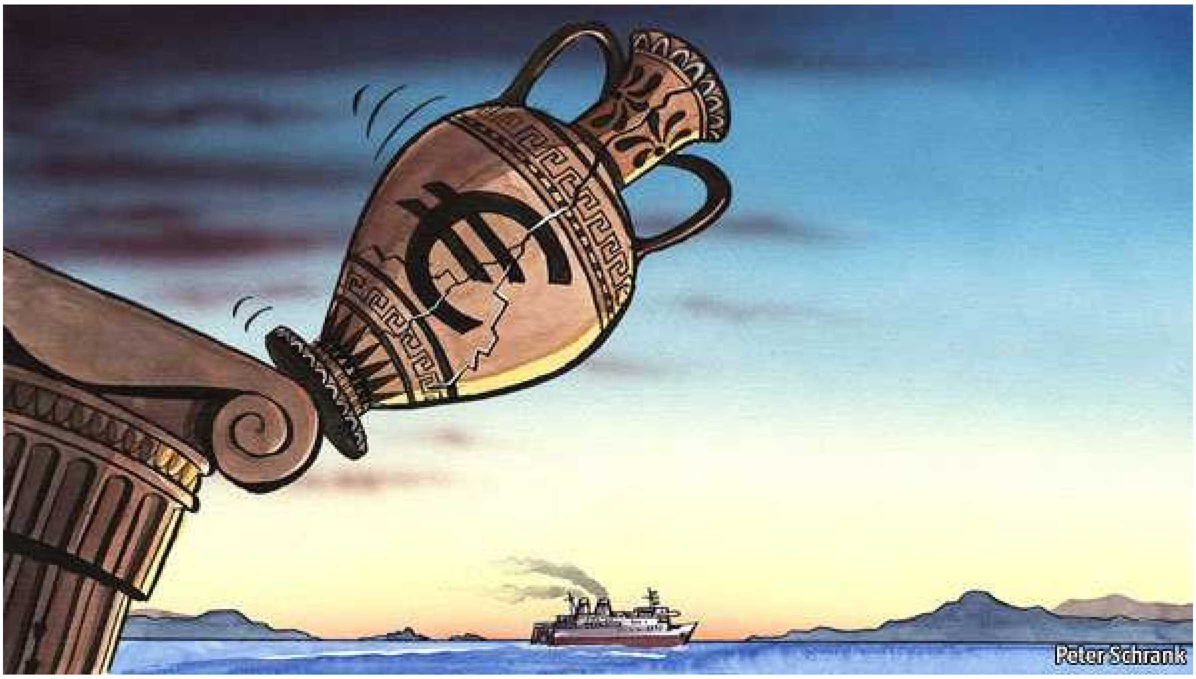
Charlemagne

Default options

The euro zone's leaders are seeing their political choices narrow



EVANGELOS VENIZELOS is a big man, built more like a rugby forward than a bookish finance minister. As the politician now charged with fixing Greece's broken finances, he will need to muster all his strength. On his first outing to meet European colleagues in Luxembourg this week he found himself like a prop pinned under a ruck, with studs tearing into his flesh.

The inexperienced Mr Venizelos left himself dangerously exposed. He tried to reopen the austerity and labour-reform package, particularly the pace of privatisation, that is a condition for receiving more bail-out money and saving Greece from default. He suggested the parliament might not meet a deadline to approve the measures by the end of the month. Worst of all, Mr Venizelos insinuated that other Europeans had no choice but to save his country because a default would be more painful for the euro zone than for Greece. Boots and fists were soon flying.

Still, he had a point. For months now, the European Central Bank and European Commission (and, more quietly, parts of the IMF and the Americans) have been urging ministers not to entertain even a modest restructuring of Greek debt, let alone a full-blown default, for fear of disastrous contagion. With signs of trouble spreading to other countries, including Spain and Italy, the words "Lehman Brothers" are uttered ever more often. The dilemma is summed up by Keynes's adage: "If I owe you a pound, I have a problem; but if I owe you a million, the problem is yours."

The assumption is still that the euro zone will somehow muddle through, at least for a while. George Papandreou, the Greek prime minister, won a vote of confidence this week, raising hopes that his reform programme, perhaps with some

tinkering, will be approved by the end of the month. Euro-zone finance ministers are due to meet on July 3rd to endorse the next tranche of loans, worth euro12 billion ($17 billion), followed days later by approval from the IMF. Greece should then stagger on until September. These days, European ministers are no longer trying to gain a few more years; a few months or even weeks will do. "They keep kicking the can down the road, but the can is getting heavier," comments one high-level diplomat.

By autumn, euro-zone ministers expect to have finalised a second bail-out for Greece that will protect it until 2014. At that point, claim the EU's and IMF's economists, Greece will have returned to growth and reached a primary budget surplus (ie, it will raise more revenue than it spends, before interest). Officials say repaying the vast debt will be "difficult but not impossible". They have to affect optimism: as they try to save Greece from default today, they can hardly admit that it is sure to default tomorrow.

But even if ultimate salvation is possible, Greece could fall into plenty of immediate traps. One is the mood at home, with almost daily mass protests outside parliament, interspersed with riots. What if Mr Papandreou cannot get a majority for unpopular reforms? Another is the sternness of the IMF, which says it cannot release next month's tranche of money before it knows that the euro zone will fully fund Greece next year. A third is the mood of creditor countries such as Germany, which have been insisting on a "substantial" contribution by private bondholders. After much argument, this is now supposed to be done "voluntarily" by rolling over the debt at maturity. But nobody really knows how much room this can create.

All this is knotted up. Without sufficient private-sector help, some countries say they will not give more money; without certainty about who pays for what, the IMF says it cannot release the funds; without the IMF, the euro zone cannot pay either; and without more tranches of help, Greece will default.

Even if Greece can be salvaged, attention is turning to the long-term survival of the euro. To Eurosceptics, notably British ones, it should be given up as a bad job. The tragedy of Greece is the inevitable outcome of EU leaders' hubris in imposing a single currency and a single interest rate on incompatible economies.

Disunited states of Europe

For Euro-federalists, such as Guy Verhofstadt, a former Belgian prime minister, the answer is to move towards a United States of Europe. Even an American such as John Lipsky, the acting head of the IMF, called on Europeans to rediscover the dream of integration. Jean-Claude Trichet, president of the ECB, says that one day there should be a European finance ministry to co-ordinate fiscal policies. He argues that the euro's performance is comparable to that of the dollar and that growth per head, price stability and even the extent of economic divergence are broadly similar in America and the euro zone. Indeed, the euro zone's aggregate deficit and debt levels are healthier than America's.

But the comparison is flawed. The euro zone is not a federal state. Its key decisions are national, and hence agonisingly slow. Fiscal transfers within the EU are far smaller than in America, so cannot help countries absorb sudden shocks. For Germany, especially, the idea of a "transfer union" is anathema. It is willing to transfer rules on fiscal discipline and the labour reforms that helped it regain competitiveness. But the idea of closer fiscal integration will not go away. The European Commission has promised to study how countries might issue common Eurobonds.

Whether it is through tougher rules that shift economic powers to Brussels, or perhaps one day a bigger fiscal union, the crisis is forcing the euro zone into more integration. As one Eurocrat puts it, "We are speleologists trapped in a tunnel. We cannot go backwards; we can only go forward." But the risk is that, in trying to avert the break-up of the euro, leaders will create a bigger political backlash, against both themselves and the EU. Mr Venizelos knows it. His rescuers know it. That is why they have been at each others' throats.

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Bank regulation

Mervyn agonistes

British banks will soon have a new master. He does not seem to like them much

THE Bank of England's governor, Sir Mervyn King, hardly bothers these days to conceal his disdain for City folk. Releasing a regular report on inflation a few months ago, he cattily observed that analysts were "paid enough" to be able to read it. Bankers who meet Sir Mervyn in person come away feeling scolded. In the debate on bank reform he seems to want to raze the banks and start from scratch.

Soon Sir Mervyn will have the power to do more than merely tell them off. On June 16th the government set out legislation that will return the task of overseeing banks to the Bank of England: a new prudential-regulation authority, sitting inside the bank, will take over the job from the Financial Services Authority (FSA). Its remit will be to ensure that individual banks comply with capital-adequacy rules, have sufficient liquid assets and spread their lending risks. The new financial-policy committee (FPC) will advise the authority on actions needed to keep the whole banking system safe.

This set-up will add to the governor's considerable powers. The supervisory head will report to Sir Mervyn, who will chair the FPC as well as the monetary-policy committee that sets interest rates. For a regulator to have cool relations with his charges is fine: chumminess can lead to laxity. His supporters insist that he is detached from banks rather than hostile to them; but many in the City detect a grudge. Can he prove them wrong?

The banks are hardly popular now because of their role in the financial crash. Still, the central bankers who failed to curb the credit and housing booms have a particular reason to feel aggrieved at the impact on their reputations. Sir Mervyn is one of finance's great survivors: he has kept the respect of politicians despite the Northern Rock fiasco and the current struggle against inflation (now at 4.5%, more than double the 2% target-see article). But his stock has fallen.

His career is bound up with the history and failures of Britain's financial system. That past, and his personality, might shape the future of regulation, too.

Shorn of strength

To understand the connection, look back to the events of the 1990s. After the bank took over interest-rate policy from the Treasury in 1997, its focus shifted away from bank regulation and financial markets. As part of the shake-up, the bank lost its role as the manager of government debt, one that ensured regular contact with the City, and the day-to-day supervision of banks, which went to a new regulator, the FSA. It retained responsibility for overall financial stability-partly as a sop to its then-governor, Eddie George, who viewed the loss of banking supervision as a slight.

The bank's role as interest-rate-setter made Sir Mervyn, then the bank's chief economist, a powerful figure. He was pivotal in creating and running the regime charged with meeting the government's inflation target. This was an ideal assignment for someone with Sir Mervyn's brains and interest in policy: there was a clear objective, a set of models and theories for guidance, and he was backed by a big team of smart economists. Financial stability was neglected-in part because the bank lacked the tools to influence it.

The primacy of the inflation target meant the bank's financial-stability wing became a backwater, a trend that accelerated after Sir Mervyn succeeded George as governor in 2003. Ambitious youngsters sensed that getting on at the bank meant working on the inflation forecast and serving the MPC. Analysts who could articulate ideas in the technical language of economics were prized; the imprecise vernacular of financial markets was scorned. Experienced staff with market nous left. One ex-staffer likens Sir Mervyn to Paul Dirac, the British physicist who shared a Nobel prize for his work on quantum mechanics: "Dirac said that if an equation wasn't beautiful, he chose to disregard it; Mervyn is purist in the same way."

So when the financial crisis struck in the summer of 2007, bank staff with an understanding of the unfolding calamity were scarce. This helps explain why the bank's initial response was flat-footed. While the Federal Reserve and European Central Bank found ways to flood their parched banking systems with liquidity, Sir Mervyn was lecturing on the dangers of moral hazard. The bank was forced to reverse course as the crisis intensified. Some of his antipathy to banks might be traced to this time, when his job seemed at risk.

The worry today is that the lack of intuition in Sir Mervyn's team will hamper the new, complex regulatory regime, too. The proliferation of committees and authorities at the bank could be a source of strife, whoever was in charge. An FPC edict to head off an incipient credit boom by, say, raising minimum capital requirements for banks might complicate the task of meeting the inflation target (by sucking credit out of the economy). A bigger risk is that the staff serving the bank's two main policy committees will not gel with the new supervisors on the ground. There is potential for a renewed clash between Sir Mervyn's acolytes, with their emphasis on rules as the basis for good policy, and the gumshoe supervisors, whose job is to understand and modify bankers' behaviour.

Sir Mervyn is the economist's economist. His blind spot over financial stability was shared by many others. His rigorous approach was needed after the erratic monetary policy of the 1980s. But that strength became a weakness in the chaos of the noughties. The risks now are that his reaction to the past clouds his judgment and that his intellectual rigidity again becomes a constraint. To prove his critics wrong, he must show he is capable of the more pragmatic approach needed for the messy business of minding banks.

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The view from London

Told you so

British smugness over the euro zone's plight is only partly justified

SCHADENFREUDE is delicious-unless it comes with a big bill attached. That sums up the tone of British debate over the euro zone's woes. Eurosceptics, including senior Conservatives, are torn between smugness and anger.

Big beasts from the Tory and Labour parties queued up this week to decry-again-what they see as the doomed folly of the single currency. Since the euro cannot last, declared Jack Straw, a former Labour foreign secretary, wouldn't it be better for the collapse to be swift, "rather than a slow death?" There have been widespread calls for Greece to leave the euro and default on its debts, so it can enter what Boris Johnson, the Tory mayor of London, said would be a state of "Byronic liberation". Ministers extolled Britain as a haven for investors.

Alas, a dark cloud hangs over the mood of vindication. There is ire at the prospect of British exposure to a meltdown in euro land. In response David Cameron promised that he would be "fighting very hard" at a Brussels summit on June 23rd and 24th to ensure that his country continues to stand aloof from EU schemes to assist Greece: in its dying days the previous, Labour government signed Britain up to a temporary euro60 billion EU rescue fund, but that is not the tool being used to help Greece. Britain was only obliged to contribute through the International Monetary Fund, Mr Cameron said-though the nativist feeling in Parliament and the press is such that even indirect exposure through the IMF is seen as a provocation.

But if the fear of being sucked into the bail-out is only partly justified, so is the smugness about having retained sterling. The big fall in the pound since 2007 is certainly a boon for exporters, one not available to their euro-zone counterparts. Yet devaluation has scarcely been painless. Mervyn King, the Bank of England's governor, reckons the weaker pound has raised consumer prices by around 6%-and so reduced living standards. Meanwhile inflation has been persistently higher than the euro-zone average. That is in part due to consumption-tax increases required to close Britain's deficit, which is larger as a share of GDP than any euro-zone country's bar Ireland.

And the full benefits of a cheaper currency have not been instantaneous. Exporters recall that sterling's last big dip, in 1992, was reversed a few years later; they may be reluctant to cut prices to win orders or to invest in new capacity until they are sure the pound's fall will last. For some the extra profit on exports is offset by the higher cost of machinery imports from Germany-which helps to explain why the economy is growing much more sluggishly than those of the euro zone's core. The vaunted wisdom of Euroscepticism has had costs as well as virtues.

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Unrest in Northern Ireland

The bogeymen return

An outbreak of rioting in Belfast

IT OUGHT to have been a festive week in Belfast. The city was gearing up to celebrate the success of Rory McIlroy, the young Northern Irish golfer who won the US Open on June 19th. But hopes of turning a handsome profit from golf tourism were instantly undermined: images of violence in east Belfast conjured up the worst memories of the bad old days.

The successive nights of rioting that overtook the city's Short Strand district this week were among the province's biggest sectarian disturbances in a decade. Hordes of hate-filled young men in balaclavas, mostly Protestant extremists, attacked police and rival crowds; several hundred people were involved. Shots were fired; a photographer was wounded, allegedly by dissident republicans. Police were forced to abandon their cars and revert to their grim old armoured Land Rovers, themselves symbols of conflict. The unionists and republicans who now share government want to persuade the world, and potential investors, that the Troubles have gone for ever. Each petrol bomb was photogenic proof of the survival of ancient animosities.

For the authorities the faint silver lining is that the disorder has been confined to a traditional flashpoint area, in which Protestants and Catholics rub up against one another, and where violence has flared intermittently for over a century. The police are confident that the latest outbreak was incited by the Ulster Volunteer Force (UVF), a loyalist paramilitary group, though its motives can only be guessed at.

The UVF claimed to have decommissioned its weapons in 2009 and has been largely inactive. But its local leaders seem to feel left behind by the peace process. Some in the UVF tried to build a political wing-modelled on Sinn Fein, the political counterpart to IRA terrorism-but their efforts petered out. Moreover some of the paramilitaries are being pursued by a police cold-cases squad for past murders.

The result is that the mini-warlords in what is an inner-city area of high unemployment have much-diminished status and power. They evidently feel alienated from a process that has embraced most of society, but which has not yet permeated these particular backstreets. Inarticulate as they are, and indifferent to their region's welfare, they seem to have ordered suggestible young men onto the streets in a bid to regain their swagger.

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This week's U-turn

Tough on crime, tough on criminals

Plans to cut the prison population by reducing sentences are ditched

You old softy

TO ITS growing list of U-turns, the government added another this week. Plans to halve the jail terms of criminals who plead guilty early were dropped from an overhaul of sentencing; instead, in a bill published on June 21st, some tariffs were raised. A bid by Ken Clarke, the justice secretary, to push liberal penal reform has flopped. David Cameron seems intent on reclaiming the Conservatives' tough reputation on law and order: polling suggests that his coalition government is most adrift from popular sentiment in this area.

Penal policy plainly needs to change. Prisons are overcrowded; prisoners spend most of each day lying on their beds; almost half reoffend within a year of getting out. This failing system is expensive: each prison place costs pound45,000 a year. And the justice department must lop 25% off its pound8 billion annual budget by 2015.

Responding to this dual challenge, Mr Clarke last year proposed sending fewer people to prison, toughening alternative sentences, improving rehabilitation and reducing reoffending through payment-by-results probation schemes. Halving the sentences of those who swiftly admit their guilt (they currently get a discount of a third) would alone have cut the 85,000-strong prison population in England and Wales by over 3,000 and saved pound130m a year by 2015, his department estimated.

Mr Clarke's ideas were endorsed by his boss. Nevertheless, they caused an uproar, on the Tory backbenches and in the tabloid press: even though crime has broadly been falling for over a decade, surveys affirm that Britons fret more than others about law and order. On the opposite side of the argument, some prison reformers worried that rewarding guilty pleas further might put undue pressure on innocents to throw in the towel. Last month it became clear that at least one sort of offender would not be included in the discount plan: an awkward reference by Mr Clarke to "serious rape", which seemed to imply that some rape wasn't, provoked fury. This week the increased discount was junked for all crimes.

Meanwhile criminals guilty of serious offences are to stay behind bars for a bigger proportion of their sentences. Indeterminate sentences, or "imprisonment for public protection", which denies prisoners the automatic right of release after serving their minimum tariff, will be reviewed, with the goal of replacing it with longer, determinate sentences. Threatening people with knives will carry a mandatory term. A new criminal offence of squatting might be created. (The right of householders to use reasonable force against burglars is to be clarified-an issue that has long been a bizarre Tory fixation.)

Some of the changes in the revised plan make sense, including more sparing use of remand, more frequent resort to well-enforced community sentences and more opportunities for paid work in prison. But overall, more rather than fewer people are likely to be locked up. So Mr Clarke must now find new cuts in his budget. Critics say his existing proposal to carve pound350m out of the pound2 billion-plus spent on legal aid risks leaving vulnerable people without representation. He now promises further "efficiency" and "administrative" savings.

To many Tories (and indeed some Liberal Democrats), this populist reverse is a no-brainer, far removed from the muddled fudge over the NHS. It still has its risks. For all that Mr Cameron insisted this week that changing course was a sign of strength not weakness, his capitulations are piling up. That could well embolden rebels in what is an increasingly bolshie parliament.

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Newspaper websites

The British are coming

Two newspapers take aim at America

ON JULY 6th Arianna Huffington, co-founder of the *Huffington Post*, will launch a British version of her website. *HuffPo*, as it is known, is a mighty force in America, where it functions as a combination of news ticker and liberal talking-shop. But it faces aggressive competition in its home market: two British news websites have stormed America.

The *Daily Mail*'s website, Mail Online, has cheerfully flouted online publishing conventions since it was relaunched in 2008. It is only loosely related to the newspaper and has its own staff. Whereas the *Daily Mail* chronicles supposed assaults on middle-class Britain by illegal immigrants, liberal politicians, germs and the BBC, the website specialises in breezy celebrity gossip. It is packed with pictures of women in bikinis. This is catnip to readers. Mail Online overtook the *Huffington Post* in worldwide readers earlier this year, and has nearly pipped the *New York Times* (see chart).

Even though the *Guardian*'s website has been popular for longer, its recent growth outside Britain is still impressive. American readers, about one-third of total visitors, come to the site mostly for its distinct take on foreign affairs: the *Guardian* is often critical of Israel. Although not as celebrity-obsessed as the *Mail*, it has more gossip than many po-faced American newspaper websites. It is also at the digital cutting-edge, with lots of blogging and tweeting.

Both outfits are bulking up in areas likely to appeal to Americans. Mail Online has added reporters in Los Angeles and New York, to keep an eye on domestic celebrities such as the Kardashians and the cast of "Jersey Shore", a reality television show. The *Guardian* will assign more reporters and bloggers to the Middle East. Both have also dispatched ad salesmen to America. At present, the *Guardian* and the *Mail* make much less money from their websites in America than in Britain. Before this year, Mail Online didn't even sell its own adverts in America, relying instead on bottom-feeding ad networks.

The *Daily Mail* is a strong, profitable newspaper in its home market. It belongs to a media group that has diversified into risk management and information services. Its American adventure is a bit of fun that might bring in a few million dollars. The *Guardian*, by contrast, is reaching for America in desperation. Its paper circulation is falling steeply; executives assume that trend will continue. Guardian Media Group lost an estimated pound33m in the year to March, and could run out of cash in three to five years. To avoid that fate, it hopes to double digital revenues to pound91m by 2013. That is probably impossible without a big injection from across the Atlantic. The global battle for readers is just beginning.

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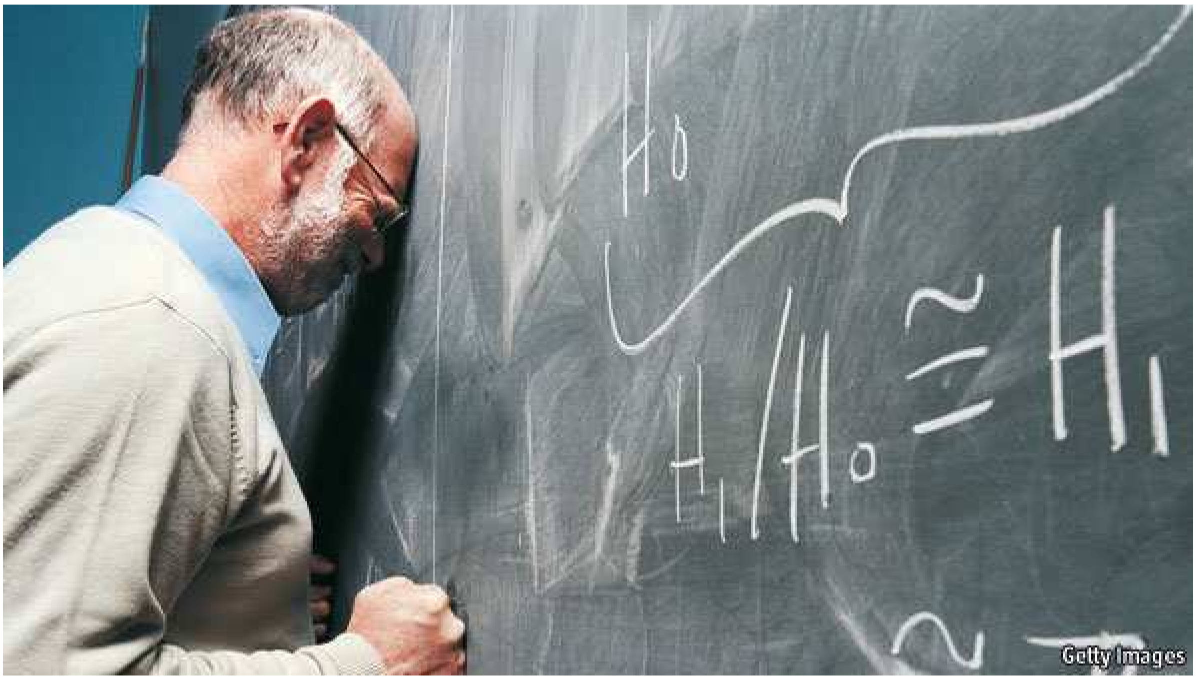
Strikes and pensions

The silent majority

The government can count on public support in its showdown with striking unions



In detention-until you're 66

PUBLIC-SECTOR employees often get angry about reforms to the way they work: witness the coalition's ravaged plans to rejig the NHS. Their hostility to direct financial threats tends to be even more intense. On June 30th trade unions including the National Union of Teachers and the Public and Commercial Services Union, which represents civil servants, are due to strike in opposition to proposed changes to public-sector pensions. Other unions-including Unison, which has 1.3m members-are threatening to strike later.

The coalition's plan, drawn up by Lord Hutton, a work and pensions secretary in the previous, Labour government, envisages the public-sector retirement age rising from 60 (in most cases) to 66. (The state-pension age, currently 65 for

men and 60 for women, is also going up for everyone to 66.) Contributions from public-sector employees should also increase, the government thinks, and a gradual shift from final-salary to career-average pensions should begin. The mooted changes come on top of a two-year freeze on public-sector pay for all but those on very low salaries.

Ministers say that pension reform is urgently required to save money at a time of fiscal austerity and lengthening lifespans, but hint that there is room for haggling on June 27th, when talks with the unions are set to resume. Encouraged by recent climbdowns over the NHS and custodial sentencing, the unions sense that the mere threat of prolonged strike action might make the government capitulate. Fearing that they are right, many Conservatives, including Boris Johnson, the mayor of London, are urging David Cameron to pass tougher laws to curb union power.

Yet there are reasons to think that the government will make only marginal concessions, if any. To begin with, serious ones would be expensive. George Osborne, the chancellor of the exchequer and pilot of the coalition's mission to fix the public finances, is particularly committed to Lord Hutton's proposals. As the government's main political strategist, he also worries that backing down will make the coalition look weak (or weaker) to both voters and the unions, inviting further demands.

Then there is public opinion. According to a recent ComRes poll, 63% of Britons think that public-sector workers will not win much sympathy as "everyone has to shoulder the burden of cuts". Just one in five disagrees. A majority of the public also believes that the strikes have no chance of changing government policy.

Part of the reason for this mood is that private-sector workers, who account for the majority of the electorate, have come to regard those on the state payroll as pampered. That view has some justification. Research suggests that working hours, sick leave and job security are cushier in the public sector. This was acceptable to many while public-sector staff were thought to earn less. But there is little evidence that such a trade-off still exists, if it ever did.

Research by the Institute for Fiscal Studies (IFS), a think-tank, shows that pay is actually slightly better in the public sector. The "raw" difference in wages is 19% for men and 26% for women. Adjusting for age and education-public-sector workers are on average better-educated, because of the large proportion who are teachers, doctors or other professionals-shrinks the gap to 2% and 7% respectively. Only in London and the surrounding areas is private-sector pay higher.

The gap in pension provision between the two sectors is even wider. The IFS estimates that employer-sponsored pensions are twice as common, and also more generous, among state employees than in the private sector, where defined-benefit schemes of the kind the government wants to curtail are becoming increasingly rare. The researchers calculate that, when pay and pensions are taken together, average remuneration in the public sector is 12% higher than in the private sector.

Perhaps the real political danger of the coming strikes is for the Labour Party rather than the governing Conservatives or their Liberal Democrat partners. Labour relies for its income on union donations. Its leader, Ed Miliband, owed his capture of the party crown in large part to support from the trade unions. Sensing the political risk, Ed Balls, the shadow chancellor, has implored the unions not to strike.

But even if the party can distance itself from union militancy, it will be harder to dispel the broader notion that Labour only represents public-sector voters: the spending splurge that the party oversaw in office is often blamed for those workers' bounteous pay and perks. For years, Tory modernisers such as Mr Cameron and Mr Osborne fretted about their party's failure to appeal to public-sector workers. Their opponents have the opposite problem.

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Bagehot

Wanted: a schools revolution

Michael Gove's school reforms must also tackle the private-state divide

IF A big test of a reforming minister is telling painful truths about failing public services, Michael Gove, the education secretary, has the makings of a bold reformer. But with a bit more courage, he could transform not just England's schools but the country.

In a recent flurry of interviews and speeches to press the case for change, Mr Gove, a Conservative, has declared public examinations "discredited" by years of grade inflation. He notes that, in international surveys, English school results have stagnated while others have leapt ahead (and this after a decade in which the previous, Labour government almost doubled school spending per pupil). Only about half of English pupils achieve a decent pass in English and maths exams for 16-year-olds, Mr Gove notes: in Singapore, the proportion is four in five. In the last year for which there are figures, he laments, just 40 out of the 80,000 poorest English school pupils (defined by access to free school meals) made it to Oxford or Cambridge University. In short, he rightly says, the status quo amounts to a "moral failure".

Understandably, most attention to date has been drawn by Mr Gove's plans to raise standards in the worst-performing schools-notably by a dramatic expansion of the "academy" programme begun by Tony Blair's government. Modelled on the "charter school" movement in America, the academy programme frees headmasters from local-authority control, giving them greater powers to hire and fire staff and to design their own curriculums.

Yet Mr Gove's candour fails him when it comes to another way in which English education is an international outlier. The country is not just home to many struggling schools; it is also home to some of the world's best schools-which are private. Yes, England is put to shame by Singapore. But England has its own Singapore: a private sector in which more than nine in ten pupils achieve Mr Gove's decent pass in English and maths.

Leading private schools do even better. In the process they offer compelling evidence for the thesis that public exams, such as the GCSEs taken at 16, have been dumbed down. Defenders of the exam system say pupils work harder and teachers teach better nowadays. Well, take Westminster, a London school (full disclosure: Bagehot was a pupil). The boys were appallingly competitive and the teaching excellent 20 years ago; both remain so today. In 1994 21% of GCSEs taken at Westminster secured the top grade, A*. By 2004 the share of A* grades was 59%, and in 2009 hit 82% (at which point Westminster switched to different exams).

Such startling results should trigger curiosity, you might think. Alas, the private sector has until now been largely excluded from a broader national debate about education by questions of class, wealth and privilege-a toxic and very English mix.

Lose that old school tie

The coalition government is "terrified" of being seen publicly championing anything offered by private schools, says a close observer of Conservative education policy. David Cameron (a product of Eton and Oxford) has conspicuously chosen to send his children to state-funded faith schools, as has his Liberal Democrat deputy Nick Clegg (Westminster and Cambridge). Mr Clegg has berated Oxbridge for admitting too few state pupils. Otherwise, the subject of fee-paying schools is mostly avoided.

On the left, too many assume that private-school success is a distasteful irrelevance, which cannot be reproduced elsewhere. In his recent memoirs, Tony Blair (educated at Fettes, a Scottish private school) recalls fierce rows with Labour colleagues unwilling to consider why private schools worked, beyond a conviction that schools with wealthy, middle-class parents, admission by academic selection and nice facilities were bound to succeed.

Nationally about 7% of children are privately educated, but in affluent areas with a shortage of good state schools such as central London, almost 20% of secondary-age children go private. That is a huge vote of no confidence in the state. Critics assume that private parents are rich snobs trying to avoid the lower orders, says Anthony Seldon, headmaster of Wellington College, a boarding school. Not so, he says: many parents make sacrifices to pay school fees, remortgaging houses or asking grandparents for help. Many would love to find excellence in the state sector.

And therein lies a glimmer of hope. Without much fanfare, a pioneering band of schools are slowly eroding a barrier between state and private education that Mr Seldon calls "the biggest wasted opportunity in Britain". Wellington College is one of half a dozen private schools now sponsoring state academies. Ancient bodies such as the Haberdashers' and the Mercers' companies are building networks of private and state schools. A consortium of state and private schools is planning a sixth-form college in the East End of London to get gifted students into good universities.

Mr Gove preferred this week to talk up schools being planned by parents' groups and Everton, a football club. But his junior ministers have offered private-state partnerships discreet support. What Lord Adonis, a former Labour schools minister close to Mr Blair, called the "educational DNA" of the best private schools-independence, restless innovation, an impatience with excuses for failure and the unabashed pursuit of excellence-can be seen in a growing number of new academies.

A thousand flowers are at last blooming in English education, and the most imaginative private schools want to play their part. Educational apartheid is one of the craziest aspects of modern England. Even if the private-state divide can only be narrowed, the country would be changed greatly for the better.

If Mr Gove can improve the worst state schools, he will go down as a great reformer. But he should be braver still. If he can detach academic excellence from the national obsession with poshness, he will be remembered as a revolutionary.

Economist.com/blogs/bagehot

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A new row about the IPCC

A climate of conflict

The world's climate experts must work harder to avoid conflicts of interest

PANELS of experts assessing scientific investigations tend to be messy affairs, particularly when their customers are governments. People with expertise in one field, such as renewable energy, may have a bias towards it. Summaries of their work are the result of political negotiations. And findings are further boiled down in an attempt to win media coverage.

Much of this can be seen in a new "special report" on renewable energy by the Intergovernmental Panel on Climate Change (IPCC), which was released last week. Possible conflicts of interest, revealed by Steve McIntyre, a blogger, have led to another controversy about the panel-only 18 months after its embarrassment over an incorrect claim about the imminent demise of the Himalayas' glaciers.

For a start, the press release about the report was misleading. "Close to 80% of the world's energy supply could be met by renewables by mid-century if backed by the right enabling public policies, a new report shows," it claims. In fact, the report merely discusses the assumptions needed to produce this outcome, one of the more extreme scenarios the IPCC looked at.

A poorly written press release might have caused less of a stir, were it not for the fact that Greenpeace had come up with the scenario. Its development was led by Sven Teske, director of the group's renewable-energy campaign. He was also one of the 12 authors of the chapter in question. What is more, a Greenpeace publication based on this scenario was graced by a foreword written by Rajendra Pachauri, the IPCC's chairman.

As if to underline such problems, when the governments that make up the IPCC met in May to release the summary of the report, they also adopted, for the first time, a policy on conflicts of interest among expert authors. Such a policy had been strongly recommended by an outside panel asked to look into the IPCC last year.

Although Mr Teske's case produced headlines, it is not necessarily the most worrying conflict of interest. Environmentalists are concerned about the number of "pro-dam" people on the team of authors reporting on hydropower. And it is not just the authors that may be conflicted. Each chapter of an IPCC report goes through a review process to ensure that all comments have been addressed satisfactorily. One of the two editors overseeing this process for the chapter on wind energy was Christian Kjaer, the boss of a lobbying group, the European Wind Energy Association. He points out that he did not seek the role of review editor, but was asked when someone else dropped out. Given the procedural nature of the task, he does not think that he had a conflict of interest.

Personal bias can be overcome with large, balanced author teams, but in the case of the report on renewables it is not obvious there was such a balance. The report discusses the downsides of various renewable energies, the challenge of incorporating them into existing infrastructure at scale and the vast if poorly bounded costs of deploying them: $1.5 trillion to $7.2 trillion in the 2020s, depending on the scenario. But the summary, in particular, is largely upbeat.

A case in point is the generating capacity of renewables. The report discusses the fact that this is smaller than for other forms of power generation. But the summary glosses over the problem, for instance by not mentioning that, although renewables have accounted for almost half the world's new generating capacity in the past two years, the other half has probably generated a lot more electricity.

This is not all the boffins' fault. Some countries, such as Germany, which nominated Mr Teske, are very keen on renewables-and wanted the summary to reflect this. Brazil has little interest in anything that can be seen as biofuel-bashing.

The lesson of the latest IPCC row is that its authors and organisers must fight harder against groupthink-and speedily implement the new conflict-of-interest policy. It is wrong, as Mr Pachauri seems to think, that the policy should not immediately and fully apply to everyone involved in the panel's current climate assessment. It would be churlish to see no progress on reforming the IPCC, but blindness to believe there had been enough.

Illegal drugs

Home-grown highs

The narcotics business is changing from an international trade to a local affair

LIKE all canny entrepreneurs, drug dealers have a knack for branding their goods with evocative names. Moroccan kif, Nepalese ganja and Bolivian marching powder-such labels add cosmopolitan glamour to a seedy business. Yet according to a report by the United Nations Office on Drugs and Crime (UNODC), published on June 23rd, changes in consumption patterns and production techniques mean that the trade is becoming less globalised-and somewhat less alluring.

Climatic conditions still dictate where some drugs are grown. Virtually all the world's cocaine comes from Colombia, Bolivia and Peru. Three-quarters of global opium production is in Afghanistan, with Myanmar and Mexico making up most of the balance. But cannabis plants, by far the world's most popular illegal drug, are as happy in a Western window box as on a Himalayan hillside. Likewise, synthetic drugs-amphetamine, methamphetamine and ecstasy, plus a growing list of new potions-can be cooked up in factories anywhere (and increasingly with harmless ingredients: researchers at Harvard University are trying to make lysergic acid, the basis for LSD and many other pharmaceuticals, from baker's yeast).

It is these mobile drugs that are now increasing in popularity. In America, where cannabis consumption had been falling, the UNODC has spotted a "resurgence". More than three in ten 18-year-olds and more than one in eight 14-year-olds now use it. American teenagers, after a period of indifference, have also rediscovered ecstasy. In Western Europe cannabis consumption is stable, but it has increased in the continent's east, as also in Latin America. Asia has seen a rise in the use of synthetic stimulants, now the world's most popular illegal highs after cannabis.

This new localism has made life more comfortable for dealers, because they have been able to shorten their supply chains. Most cannabis is now grown in its country of consumption, according to the report. In Japan the number of arrests for domestic cannabis cultivation increased by 17% in 2009, whereas the number of arrests for importing fell by almost half. Sixty countries now report synthetic-drug factories on their territory. More than 10,000 were shut down in 2009, mostly in the United States. But they sprang up in Asia, too: China discovered 391, Indonesia 35-a record. In fact, Indonesia may now have replaced Europe as the main supplier of ecstasy to South East Asia, reckons the UNODC.

This industrialisation of production brings new problems. Cultivating cannabis in factories tends to improve its quality, which partially explains why stronger varieties have become more widespread. In America average concentrations of tetrahydrocannabinol, the psychoactive ingredient, doubled in the 1990s, as growers focused on stronger, more expensive

cannabis. Synthetic-drug laboratories have begun to market new-and in many places still unregulated-"legal highs", such as piperazines and mephedrone (banned last year in the European Union).

By contrast, countries in Latin America and Asia, that have so far supplied the rich world with most drugs, may welcome the shift to local production. The cocaine route from the Andes to America has brought mayhem to regions along the way, first in Mexico and now in Central America. If gringos switch from cocaine to home-grown drugs, many in Latin America will breathe a sigh of relief.

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Domestic workers

Free the maids

A new treaty aims to stop abuse

After the ordeal

WITHOUT them many an economy would grind to a halt: the global army of between 50m and 100m domestic workers, most of them women and children. Yet tucked away in kitchens and nurseries, mainly in the Middle East and Asia, their wages often go unpaid, they are rarely granted any time off, and many face physical and sexual abuse.

The International Labour Organisation (ILO) hopes to change all this with a new treaty adopted on June 16th at its annual conference. The Convention Concerning Decent Work for Domestic Workers has been three years in the making. Its goal is to limit working hours, guarantee weekly days off, ensure a minimum wage and protect domestic workers from violent employers.

Only a few delegates-government officials as well as national representatives of employers and workers-voted against (Swaziland and a couple of employer groups, including the Confederation of British Industry), but there were some

notable abstentions. Predictably, they included Malaysia. A series of abuse cases led Indonesia to ban its citizens from going to work there as maids from 2009 until May this year. More surprisingly, the British government, too, preferred not to vote either way. It said the treaty would be too onerous, particularly the parts regulating working hours and health and safety.

In contrast, the six wealthy monarchies of the Gulf Co-operation Council (GCC), where abuse of domestic workers is common, had a change of heart. Initially, they opposed the convention, arguing that it was not only impractical, but unnecessary: workers, they said, were treated like members of the families who employed them-though ask Sumiati Binti Salan Mustapa, a maid whose Saudi employer stabbed, beat and burned her. This year the GCC shifted its position and even suggested several changes that strengthened the treaty.

The convention now has to be ratified by governments, which is likely to take several years. Some countries may never follow through, despite having voted for the treaty. In the meantime, abuses continue, although things have recently improved. In the Middle East several countries are drafting legislation about domestic workers and are looking to the convention for guidance. Others now have hotlines for domestic workers to report abuse.

Yet the most encouraging local change is the emergence of many Facebook groups and blogs, such as Migrant Rights, that talk about abuse. They show that younger people in the Middle East and Asia are increasingly embarrassed about the exploitation of expatriate workers in their countries. That may do as much as any treaty to improve the plight of domestic workers.

Index | A special report on China

Rising power, anxious state

In less than a decade China could be the world's largest economy. But its continued economic success is under threat from a resurgence of the state and resistance to further reform, says James Miles

AT THE HEIGHT of the Qing dynasty, back in the 1700s, China enjoyed a golden age. Barbarians were in awe of the empire and rapacious foreigners had not yet begun hammering at the door. It was a *shengshi*, an age of prosperity. Now some Chinese nationalists say that, thanks to the Communist Party and its economic prowess, another *shengshi* has arrived.

Last year China became the world's biggest manufacturer, displacing America from a position it had held for more than a century. In less than a decade it could become the world's largest economy. Foreigners are again agape.

China's rapid recovery from the global financial crisis, and the West's continuing malaise, have had a profound psychological impact on many Chinese. Emotions ranging from pride to *Schadenfreude* permeate official rhetoric. Diplomats treat their Western counterparts with a tinge of condescension. What is great about socialism, crowed the prime minister, Wen Jiabao, in March last year, is that it enables China "to make decisions efficiently, organise effectively and concentrate resources to accomplish large undertakings". In the eyes of some Chinese, and even some foreigners, authoritarianism has gained a new legitimacy.

A big parade of missiles, tanks and goose-stepping soldiers in central Beijing in October 2009, the capital's first such display in a decade, was described in official reports as a "grand ceremony of the *shengshi*". A group of generals and senior officials enlisted 60 artists to commemorate the party's 60th year in power that year by painting a 120-metre-long scroll called "A Picture of a Chinese Harmonious *Shengshi*". The panorama depicted the soaring skylines of China's great cities, interlaced with the mountains, rivers and clouds beloved of traditional painters. There were ethnic minorities dancing joyously in Tiananmen Square, a rocket taking off, a wind farm and even a mist-wrapped Taiwan. In the past couple of years the *shengshi* has brought the recalcitrant island closer, with cross-strait flights and a free-trade deal.

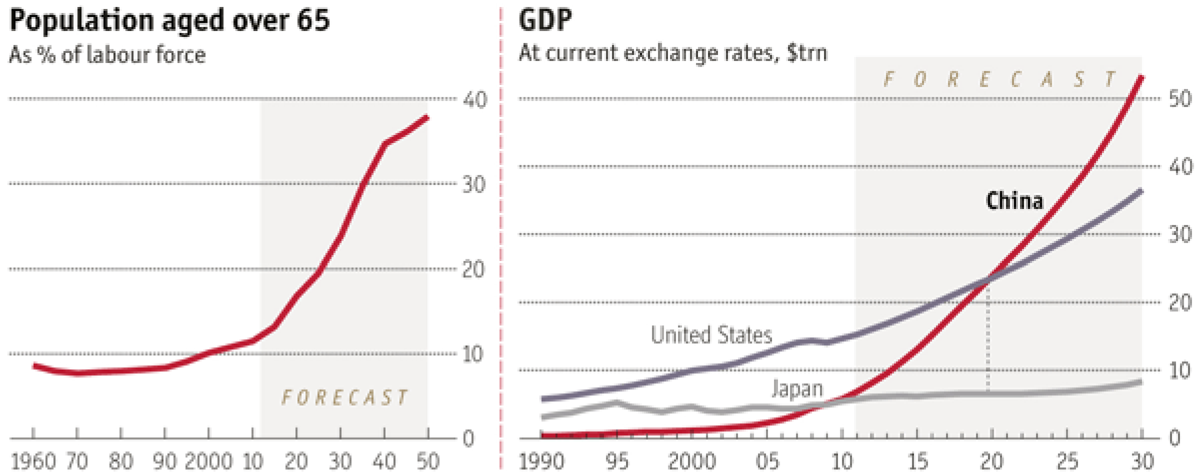
To some observers in an insecure West, the balance of global power is shifting inexorably in China's favour. Recent book titles capture the mood: "In the Jaws of the Dragon: America's Fate in the Coming Era of Chinese Hegemony" (by Eamonn Fingleton, 2008); "When China Rules the World: The End of the Western World and the Birth of a New Global Order" (by Martin Jacques, 2009); "The Beijing Consensus: How China's Authoritarian Model Will Dominate the Twenty-First Century" (by Stefan Halper, 2010). As William Kirby of Harvard University notes, anxious books about China's rise have a long history in the West. There was a spate of them in the early 20th century: "New Forces in Old China: An Unwelcome But Inevitable Awakening", by Arthur Brown, set the tone in 1904. But other rising powers-Japan, Germany and America-got even more attention. Today China is the chief object of worry.

Chinese publishers have been cashing in too. Bookshops (which stock only works of which the party approves) are stacked with volumes on the "China model" and the failure of liberal economics. The Chinese Academy of Social Sciences struck a rare note of modesty in a report last October. It rated China a mere 17th in a global league of "national competitiveness". But it pointed out that the country had risen from 73rd place in 1990 and had left India, which was ranked 42nd, in the dust. China's aim, the report said, should be to reach the top five by 2020 and be second only to America by 2050. Its universities are producing swelling legions of scientists, but it seems there are still not enough of them to allow the country to join the top ranks just yet.

All change

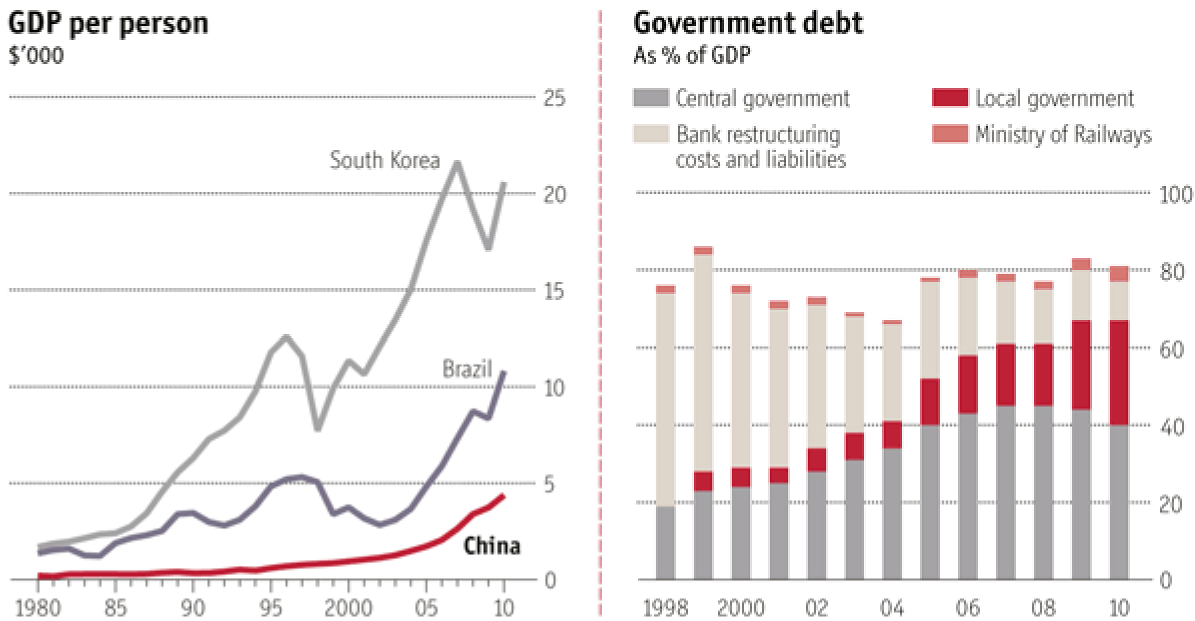
For all the chest-thumping, though, China's leaders are more cautious than either their underlings or the state-controlled publishing industry. They avoid the term "China model" and do not publicly boast of a *shengshi*, even though they allow their media to talk of one. Indeed, they appear more nervous now than at any time for over a decade. They have massively increased spending on domestic security, which in this year's budget has overtaken that on defence for the first time. The government has been reviving a Maoist system of neighbourhood surveillance by civilian volunteers. In the past few months the police have launched an all-out assault on civil society, arresting dozens of lawyers, NGO activists, bloggers and even artists. The Arab revolutions have spooked the leadership. From its perspective, the system looks vulnerable.

Chinese leaders have other reasons to fret. Late next year, probably in October, the party will hold a national congress, the 18th since its founding 90 years ago. This meeting, a smaller one of the party's central committee immediately afterwards and a session of the legislature in March 2013 will endorse the biggest shuffle in China's leadership for a decade. The president, Hu Jintao, and Mr Wen will step down from the pinnacle of power, the nine-member standing committee of the Politburo. A younger generation will begin to take over. Leadership changes on this scale always make officials anxious. Although the most recent one, in 2002, passed without incident, earlier such transitions triggered dramatic events: a coup in 1976, debilitating power struggles in 1986-89 and mass unrest in 1989. Just because the last one went well does not mean this one will.



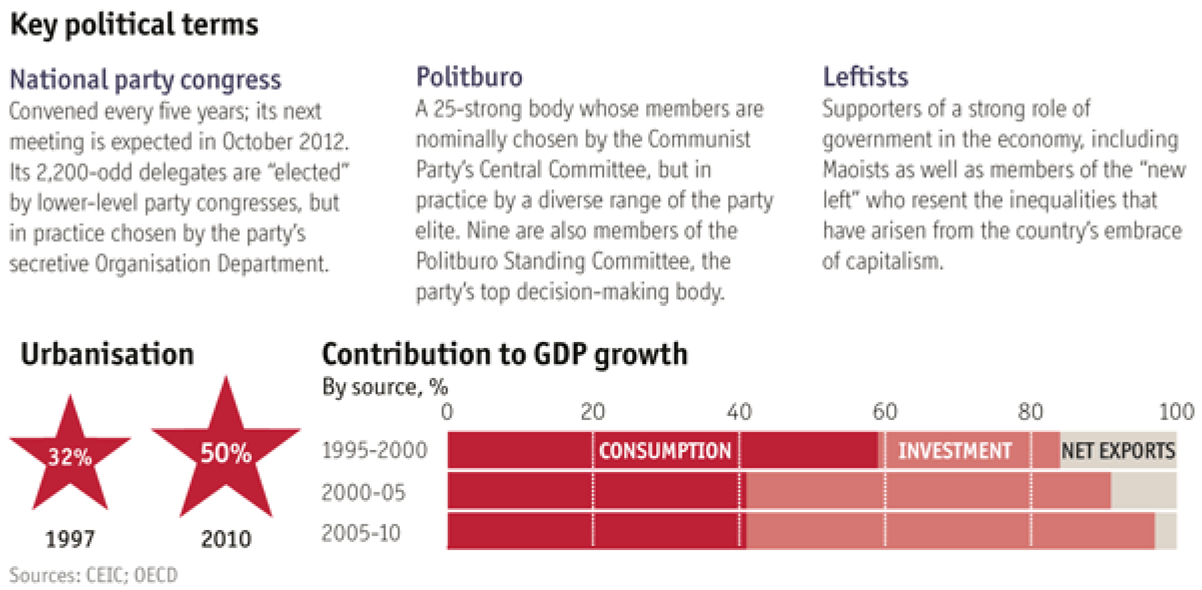
Sources: Lombard Street Research; Economist Intelligence Unit

The new leadership will not have such an easy ride with the economy, which on average has grown by over 10% a year since 2002, despite the trauma of the global financial crisis. China's demographic advantage-an abundant supply of labour in the countryside-is beginning to wane. In a few years the working-age population will peak. Without huge and politically risky policy changes it will become increasingly difficult to maintain the rapid rate of urbanisation that has been one of the main drivers of growth. Looking towards the 2020s, many Chinese economists worry about falling into a "middle-income trap": losing competitiveness in labour-intensive industries but failing to gain new sources of growth from innovation.



Sources: IMF; GK Dragonomics

China's leaders will find it enormously difficult to rebalance China's economy so that growth is led by consumption rather than by exports and investment. Their efforts will be hampered by the growing clout of state-owned businesses. In the past decade these have risen from the ashes of tens of thousands of government-owned enterprises dismantled in the 1990s. Their numbers are now much smaller, but their economic and political influence is enormous and growing.



Banks are still almost entirely in government hands. Their profligate lending to other parts of the state empire, in order to keep the economy booming after the financial crisis, will revive a bad-debt problem that China thought it had licked years ago. Many of the descendants of those who led the party when it came to power in 1949-the likely big winners in next year's realignment-have strong ties with state-owned firms.

China is likely to disappoint those who believed that the country's embrace of globalisation would usher in greater political freedoms over the next few years. James Mann, an American journalist, gave warning of this in a 2007 book, "The China Fantasy: Why Capitalism Will Not Bring Democracy to China", suggesting that a quarter of a century from now China's "current system of modernised, business-supported repression could well be vastly more established and entrenched". A lot can happen in 25 years, but the line-up for next year's change of leadership does not give cause for optimism.

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China's new leaders

The princelings are coming

Next year's changes in the leadership will bring on a new generation of privileged political heirs

THE RUGGED REMOTENESS of Chongqing, a region in south-western China about the size of Austria, made it an ideal temporary home for the government during the Japanese invasion in the 1930s-40s. In the 1960s Mao Zedong moved strategic industries there to protect them from a feared Soviet invasion. Recently Chongqing has become a stronghold of something rarely seen in China since Mao's day: charismatic politics.

The region's party chief, Bo Xilai, is campaigning for a place on the Politburo Standing Committee in next year's leadership shuffle. He looks likely to succeed. Like every other Chinese politician since 1949, he avoids stating his ambitions openly, but his courting of the media and his attempts to woo the public leave no one in any doubt. Mr Bo's upfront style is a radical departure from the backroom politicking that has long been the hallmark of Communist rule and would seem like a refreshing change, were it not that some of his supporters see him as the Vladimir Putin of China. Mr Bo is a populist with an iron fist. He has waged the biggest crackdown on mafia-style gangs in his country in recent years. He has also been trying to foster a mini-cult of Mao, perhaps in an effort to appeal to those who are disillusioned with China's cut-throat capitalism.

He does not appear to be aiming for the very top. Hu Jintao's posts of president, party chief and military commander are almost certain to go to Xi Jinping, the vice-president, and Wen Jiabao's job as prime minister is likely to be taken by Li Keqiang, his senior deputy. But Mr Bo could well be offered the portfolio of China's internal security chief, currently held by Zhou Yongkang, with whom he is believed to have close ties. This would give him huge clout in the new line-up. Xinhua, a government-run news agency, in December named Chongqing as China's "happiest" city, in a hint that Mr Bo is destined for great things.

Both Mr Bo and Mr Xi belong to an emerging political force in China commonly known as the *taizidang*, or "party of princelings". These are the offspring of senior officials, including Mao's old comrades-in-arms. Mr Xi is the son of Xi Zhongxun, a hero of the epic Long March of the 1930s. Mr Bo's father, Bo Yibo, was also a Long Marcher. Both fathers held senior positions under Deng Xiaoping. In the 1990s the princelings were viewed with great suspicion by many in the party who resented their use of blood ties to secure top positions, but in more recent years party leaders appear to have rallied around them. They probably calculate that people like Mr Bo and Mr Xi are the safest bet for upholding the party's traditions, and crucially for holding on to its monopoly of power.

Mr Xi (who adores Hollywood movies about the second world war, according to a WikiLeaks cable) and the Jaguar-loving Mr Bo exude the sort of self-confidence that comes with a privileged upbringing. Like Western celebrities, they excite much tattle, albeit not in the party-controlled media. Mr Xi's wife, Peng Liyuan, is a glamorous folk-singing star in the People's Liberation Army. A foreign businessman calls Mr Bo China's "best-dressed person". His son, Bo Guagua, is

now studying at Harvard University after a stint at Oxford where his raffish behaviour, caught on camera, became an internet sensation in China (notwithstanding the censors' best efforts).

The new left

Despite such diversions, Mr Bo is a darling of China's "leftists". These include diehard Maoists (who are a marginal force in Chinese politics, but still enjoy some appeal among retired officials and workers laid off from state-owned enterprises) as well as social democrats who want a fairer distribution of wealth. Many in this camp believe that China is far from enjoying the golden age now being proclaimed by some. The country is too divided between rich and poor to be experiencing a *shengshi*.

Bo Xilai and Peng Liyuan add a touch of glamour to the world of Xi Jinping (centre)

Mr Bo's Maoist revival has included a campaign to encourage the singing of "red songs", especially classics from the Mao era (one official newspaper cited Chongqing residents' enthusiasm for this as one reason for its "happiest" award). Mr Bo himself has taken the stage with fellow officials to croon a few numbers, and has issued a list of 27 favourites (including "I Am a Soldier", from the early days of Communist rule, and "China, China, the Bright Red Sun Will Never Set", from 1977, the year after Mao's death). In Chongqing, party cells in universities, schools, government offices and state-owned businesses organise red-song clubs and competitions. The Chongqing government has even been encouraging citizens to send "red instant messages" on their mobile phones. Mr Bo took the lead by sending one citing the Great Helmsman: "What really counts in the world is conscientiousness, and the Communist Party is most particular about being conscientious." Tens of thousands of Chongqing officials are now required to spend a week every year living and working with a peasant family.

Chinese leaders may shy away from claiming to have found a "China model", but Chongqing's leaders are not so bashful. Piled up in the foyer of the city's main government-owned bookshop are volumes of a new work called "The Chongqing Model". Written by three leftist scholars, it reads like a manifesto for Mr Bo. The authors say the anti-mafia campaign will help prevent a "colour revolution" of the kind experienced by numerous former communist states and by some Arab nations in recent years. They speak of the "original sin" of private entrepreneurs who got rich by shady means. The anti-mafia drive, they quote the city's mayor, Huang Qifan, as saying, helped restore order to "an economy of scoundrels, an economy of rascals". Mafia-controlled businesses, the writers say, employed 200,000 people. By stepping in and assuming "trusteeship", the government ensured that none of them lost their jobs.

Liberals in Beijing worry that Mr Bo's campaign has shown little regard for legal process, much less the independence (however notional) of the judicial system. Police and judges have been instructed by party cadres whom to target and what punishments to mete out. A prominent defence lawyer hired by one alleged mafia boss was himself jailed for allegedly attempting to persuade his client to lie in court. Some independent lawyers in Beijing say Mr Bo's real motive was to deter

lawyers from acting for accused gangsters. Liberals fear that the crackdown on dissent in China in recent months will continue even after the princelings have taken power because the new leaders will be fearful of challenges to their authority.

The authors of the "The Chongqing Model" would like to steer the economy onto a different path. They speak scornfully of Shenzhen, a freewheeling "special economic zone" bordering on Hong Kong beloved of China's liberal economists. They prefer a bigger role for the state. Chongqing officials proudly note that the municipality, which ranked 19th among Chinese provinces by value of its state assets in 2003, has since moved up to number four, thanks to a more than sevenfold increase in their worth to 1.25 trillion yuan ($192 billion).

But Mr Bo's predilection for state-owned enterprises has a populist streak too. Whereas most such firms in China hand over little of their profit to the state, causing widespread resentment, officials claim that Chongqing's state businesses have been supporting projects for the less well off. These include a huge one launched in 2010 to build 800,000 subsidised apartments within three years, at a cost of 120 billion yuan ($18.5 billion).

This housing scheme has been widely praised in the national media. But as this special report will argue, if China's state-owned enterprises enjoy a renaissance under China's new leaders, it will be to the detriment of competition and increased consumption as a new driver of growth. Politically, their growing power (along with the salaries and benefits enjoyed by their employees) is likely to exacerbate social tensions, especially if China's growth falters, forcing private companies to scale back.

Mr Hu at least will be able to point to a legacy of his decade in power that makes many Chinese proud: double-digit annual growth and a much higher global profile. Mr Xi's rule could be far more troubled.

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Growth prospects

Beware the middle-income trap

China's roaring growth cannot last indefinitely

But will they consume enough?

CHINA'S LEADERS ARE usually shy of telling things as they are, but the prime minister, Wen Jiabao, put it bluntly when he described China's economy in 2007 as "unstable, unbalanced, unco-ordinated and unsustainable". Some foreigners may extol China's handling of the global financial crisis, but Mr Wen has stuck to his guns. The phrase even crops up in China's recently adopted five-year economic plan, standing out as an indirect admission of the failings of his own administration and as a marker for the next.

For all its problems, China in the coming 10-15 years is still likely to reach several symbolic milestones. The IMF predicts that in 2016 it will become the world's largest economy on a purchasing-power-parity basis. The Economist Intelligence Unit, a sister organisation of this newspaper, reckons that on the basis of market exchange rates China will attain that glory in 2020. By the end of this decade, according to Daiwa Securities, GDP per person in Shanghai, China's richest city, could be almost the same as the average for America in 2009.

And for all the bubbliness of China's property market and the reckless spending of local governments, the country will probably avoid a crippling debt crisis. China has foreign-exchange reserves of more than $3 trillion and ran a modest budget deficit of 2.5% of GDP last year. Its worries are longer-term. The economy will certainly begin to slow in the next few years after three decades of nearly 10% average annual growth. Exports will be constrained by depressed Western markets, and investments in fixed assets will produce diminishing returns. But the slowdown will be less pronounced if the government succeeds in boosting consumption as a new growth engine.

Arthur Kroeber of GK Dragonomics, a consultancy, says the country still enjoys a considerable tailwind from urbanisation and a huge potential for productivity gains as it adopts new technology. He says a scattering of white-elephant projects (including the odd ghost-town of uninhabited new housing and office developments) does not concern him: "There's no question that there are excesses, but the basic thing they are doing is sensible." Louis Kuijs of the World Bank agrees. He sees the trend growth rate easing over the coming decade, but not dramatically. New infrastructure is generally being put to good use. Even though investment as a proportion of GDP is high, China's accumulated investment in fixed assets is still low. Real wages have been rising strongly, which should help boost consumption. Standard Chartered, a bank, says that although China's public debt is considerably higher than the 17% of GDP officially cited, it remains manageable. Even after allowing for bad loans to local-government investment companies, it runs at 80% of GDP, the bank estimates, about the same as Britain's last year and well below Greece's.

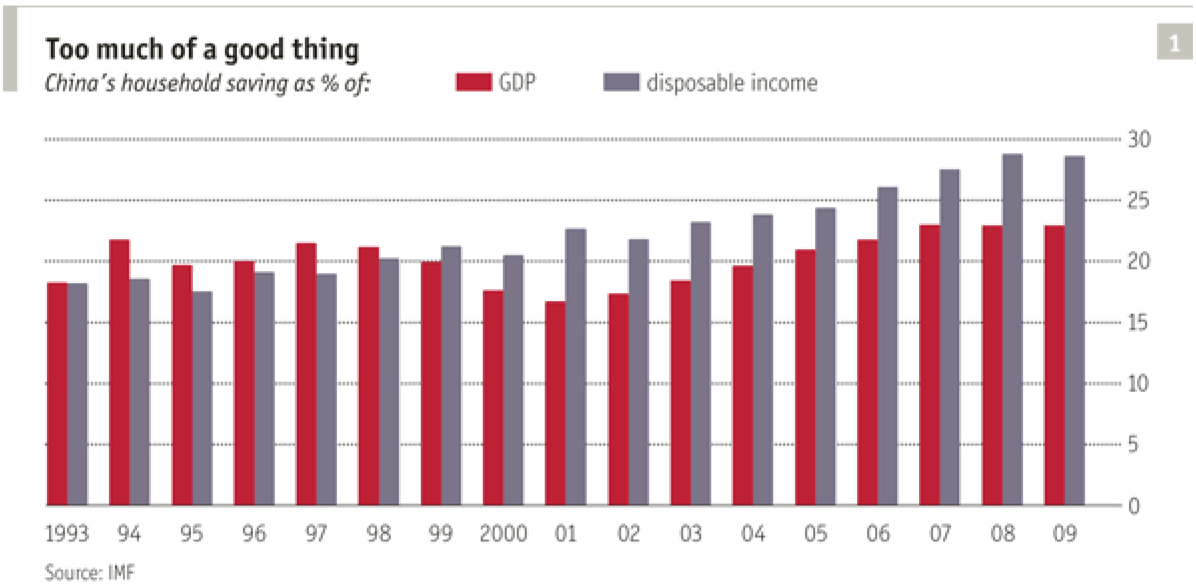
Chinese leaders are perennial worriers about inflation, not least because of its role in fuelling the discontent that led to the Tiananmen Square protests of 1989. But even though it rose to 5.5% in May, considerably above the government's 4% target for the year, it shows little sign as yet of returning to previous highs of about 20% in 1988 and more than 25% in 1994. It also has a useful political side-effect, easing some of China's tension with America over the value of its currency. America's Treasury says that because of the higher inflation rate in China, the yuan is in effect appreciating against the

dollar by more than 10% a year. Chinese leaders have been debating whether to push interest rates higher, but Mr Kuijs says Chinese policymakers have become more tolerant of medium rates of inflation.

Yukon Huang of the Carnegie Endowment for International Peace, a think-tank in Washington, DC, says doomsayers are wrong to be so concerned about the fall in the ratio of household consumption to GDP. True, it has dropped from around 50% two decades ago to 35% today, among the lowest levels in the world, whereas investment is among the world's highest; but such a decline, he says, is not unusual for an industrialising country. The efficiency of stimulus spending may be questionable, "but how efficient do you expect stimulus money to be?" He thinks growth could remain at 7-8% for a long time.

The bears' grumbles

But many analysts are far less sanguine. Some worry that China could be approaching a Japanese-style crisis: a boom in exports and investment along with bubbly property markets, followed by many years of stagnation. In China's case the added sting would be that it has not yet got rich. Officials and experts debate endlessly whether the country is slowly heading towards a "middle-income trap". China was already a lower-middle-income country last year, with a GDP per person of around $4,400. The fear is that it might suffer the same stagnation and turbulence as Latin American economies in the 1980s and 1990s.

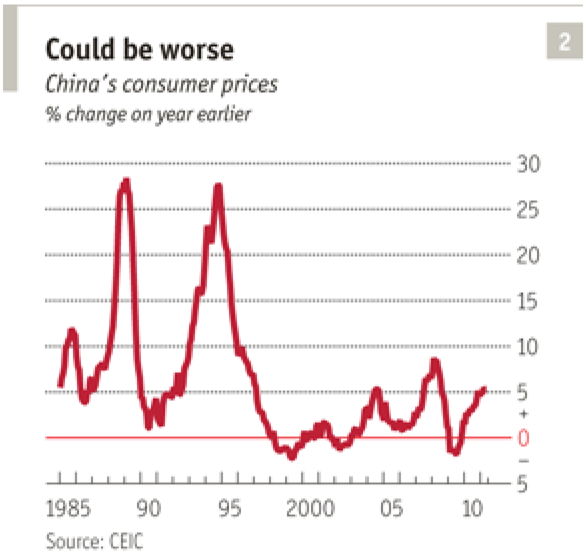


The drafters of the new five-year plan adopted in March were clearly hoping to head off such a calamity. Five-year plans have evolved since the Mao era when they were used by the government to micromanage the economy, but they are still meant to play a crucial role in setting the economic tone. "China model" fans love them because, at least in theory, they commit leaders to an economic strategy that will not be undermined by the chop-and-change policymaking of democracies. When Mr Wen's successor takes over in 2013, the current plan will still have more than two years to run. It calls for faster change in the "pattern of economic development" to address the imbalances, and sees boosting consumption as critical to this.

Mr Wen himself is no touter of a China model. His previous five-year plan, which took effect in 2006, was also intended to shift the economy away from too much reliance on exports and investment. It set a target of 7.5% annual growth in GDP for the plan period, against 8% for the previous one. Instead, the rate accelerated to about 11% a year, compared with an average of 9.5% in the first half of the decade. Household consumption as a proportion of GDP fell sharply. And China's 4 trillion yuan stimulus programme (about $620 billion at current exchange rates), launched in November 2008, allowed banks to lend almost at will, mostly to state-owned enterprises, raising the prospect of a flood of new bad debt.

Despite Mr Wen's calls for more evenly shared prosperity, the gap between rich and poor and between cities and countryside has continued to widen. Since he took office in 2003, absolute poverty has dropped markedly. But the number of people in relative poverty (with 50% or less of the median income) grew from 12.2% of the population to 14.6% between 2002 and 2007, according to research by Terry Sicular of the University of Western Ontario and Li Shi and Luo

Chuliang of Beijing Normal University. By the end of the plan period the goal of establishing a "harmonious socialist society", a favourite catchphrase of Mr Wen's and Mr Hu's, appeared even more remote than at the beginning. Protests over local injustices, already running at tens of thousands a year, were becoming ever more frequent.



The new five-year plan adopted in March notes that the "external environment" for China's development has become "more complicated". In other words, markets abroad do not look promising. It calls for a "strategic readjustment" in China's growth model, putting even more emphasis than its predecessor on domestic demand, especially consumption. It still envisages big investments, but in the hope that these will boost household consumption in the longer term. It promises 36m new "affordable housing" units, more than Britain's entire housing stock. The hope is that cheaper homes will make it easier for the Chinese to get into the housing market without having to save quite so much. And the government has pledged to ramp up spending on health, education and other social-welfare programmes. Eventually too this could encourage people to save less and consume more.

The government also wants the high-speed railway network, already the world's longest at 8,300km, to quintuple in length by 2015. Beijing, having completed one of the world's largest airport terminal buildings in 2008, will get a whole new airport. So will 54 other cities, increasing the total number with airports by nearly one-third. These investments, officials hope, will help to boost urban growth, and with it consumption. Infrastructure targets are usually met in China because governments have little trouble with not-in-my-backyard protests.

But some economists believe this is all too much. Among the bears is Michael Pettis of Peking University, who believes that investments are becoming increasingly inefficient and that China is heading towards a "brick wall" of government debt. Growth, he says, will remain high in the early half of the decade but could drop off sharply thereafter as loans turn sour. Even in the best case, he says, growth will fall below 5%. Victor Shih of Northwestern University also points to a looming debt problem, exacerbated by the recklessness of local governments during China's stimulus-spending spree. Not being allowed to borrow directly, many of them set up companies to borrow on their behalf, using land as collateral. "There is a hidden danger of an asset bubble and [we] are facing a certain financial risk," wrote Yu Peiwei of the party's Policy Research Office in January. If the bubble bursts, land prices could plummet, leaving the banks dangerously exposed.

Bingeing on investment

Nouriel Roubini of New York University, a chronic bear, is in this camp. In a recent article he argued that the brick wall will most likely be hit between 2013 and 2015. He noted that China was spared a recession in the wake of the financial crisis because investment in fixed assets, such as transport infrastructure and factories, increased from an already very high 42% of GDP in 2008 to nearly 50% in 2010. No country, he says, could be productive enough to invest 50% of GDP in new fixed assets without eventually facing "immense overcapacity and a staggering non-performing loan problem".

It is not just foreigners who worry. Ge Zhaoqiang, a senior researcher at China Merchants Bank, gave warning in May that China's economy had become "seriously distorted" by prolonged dependence on high levels of investment. There was now

a risk, he said, of an economic downturn "unprecedented in the past 30 years" with possibly damaging consequences for China's social and political stability.

If China is not to stagnate, it will have to make a bigger effort to persuade rural dwellers to keep coming to the cities as its population ages ever more rapidly. In 1980 one-fifth of China's people lived in urban areas. Today the figure is 49.7%. Very soon the country will become predominantly urban, with over 51.5% forecast to be living in urban areas by the end of the five-year plan. This implies a slower pace of urbanisation than in the past decade. For once, however, the government is not setting its goals too low. In future urbanisation will indeed become harder.

Urbanisation

Where do you live?

Town- and country-dwellers have radically different prospects

Rus in urbe

IN DAYI COUNTY, a couple of hours' drive down a motorway from the city of Chengdu, the capital of Sichuan Province, Chinese tourists stroll through the meandering courtyards of a rural mansion. In the 1950s, soon after Mao seized power, the mansion was turned into a museum, intended as a showcase of evil. It once belonged to Liu Wencai, a landowner supposedly notorious for ill-treating his tenant farmers. Liu embodied a class despised by Mao, who came to power on the back of a promise to give land back to the peasants.

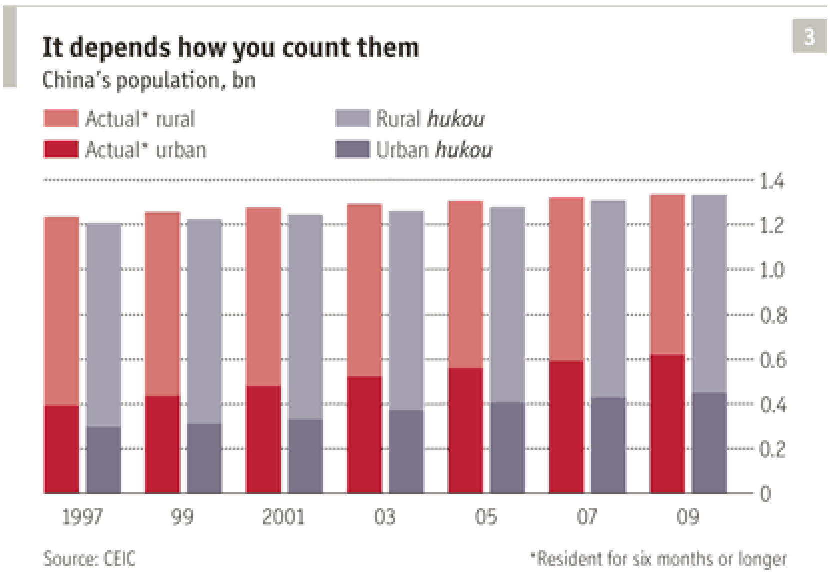
In its Maoist heyday the museum was a place of pilgrimage. Red Guards swarmed there for ritual denunciations of Liu and his ilk. A high point of their visit was a trip to the "water dungeon", a room with several inches of water covering the floor where Liu had allegedly kept disobedient farmers. Another was a series of life-size sculptures of peasants and their vicious oppressors. A politically disfavoured curator from Beijing's Forbidden City who happened to look like Liu was forced to stand next to the sculptures as a "living Liu Wencai" so that visitors could shout and (though not strictly permitted) spit at him, according to Geremie Barme of Australian National University.

The sculptures are still there, but in recent years a wave of revisionism has been sweeping across Dayi. Local officials were already having second thoughts by the early 1980s. But it was a book reassessing Liu's life published by an outspoken journalist in 1999 that finally convinced many that the man was really not that bad. His water dungeon was a government fabrication, the museum now points out. He spent a lot of money on local schools and paid for a road to be built from Chengdu to Dayi. Last year a grandson organised a get-together in Dayi for the extended Liu clan, whose members would once have been terrified of revealing their ties. More than 1,000 turned up.

The slaughter of many thousands of landlords (not including Liu, who died of natural causes) by officials and vengeful peasants shortly after the communist takeover resulted in profound changes in the system of rural land ownership. Peasants got the land Mao promised them, but only briefly. In the late 1950s the party took it back again and forced farmers into collectively owned "people's communes". The legacy of that disastrous decision, which contributed to a famine that left tens of millions dead, still weighs heavily on rural China. So too does a decision to confer hereditary status on peasants, who would be all but barred from cities to stop them rushing in to find work.

The curse of the hukou

The *hukou* system, as this one-time apartheid is commonly known, applied to urban as well as rural dwellers, but peasants got a worse deal because they received hardly any welfare benefits, and job prospects in the countryside were dismal. The system has been much eroded since the Mao era because of the need for cheap labour to fuel China's manufacturing boom. But its lingering impact, combined with the still collective ownership of rural land, will retard China's urbanisation in the years ahead just when the country is most in need of its consumption-boosting benefits. Two researchers from China's finance ministry, Chen Xiaoqiang and Liu Ling, wrote in March that it was time to start returning land to the peasants, both to spur consumption and to help defuse growing rural unrest. Most officials dare not say this so bluntly, but they admit that change is needed.



In 2007 Chengdu, and Chongqing to its south-east, were given licence to experiment. The principle of collective ownership could not be changed, but farmers' rights could be clarified and rural land markets of sorts could be established. In Chengdu, which is responsible for a large rural area including Dayi county, officials spoke of initiating a "new land reform" (hinting at similarities to the great land reform that divvied up the estate of landlord Liu). They began a drive to ensure that farmers at last got long-promised certificates showing the exact boundaries of their fields and housing as well as confirming their rights to use them (farmland is subject to a 30-year renewable contract).

Without such documents a market could not take off. Regulations dating back at least to 1997 have obliged officials to issue them. But Landesa, an American NGO, says a survey it conducted in mid-2010 in 17 provinces, along with Renmin University and Michigan State University, found that only 44% of respondents had a complete set of certificates. One in three had no documents at all. In April the central government urged the whole country to finish issuing the certificates by the end of 2012. Dayi county, chosen by Chengdu as a trailblazer for land reform, says it got the job done by the middle of last year. But one peasant fumes that officials never bothered to give her any documents and seized her house and

farmland a few months ago for a development project. "Liu was a great landlord," she says. "I wish officials today were like him."

Both Chengdu and Chongqing have gone a step further. They have set up markets for rural land derivatives, allowing farmers who create new land for agricultural use (by giving up some of their housing plots, for example) to sell the right to use an equivalent amount of rural land for urban development. Thus a developer who wants to build on a greenfield site that has already been approved for urban construction bids first for a "land ticket", or *dipiao*, which certifies that such an area of farmland has been created elsewhere. The regulations say farmers get 85% of the proceeds: good news, in theory, for those in remote, dirt-poor areas who would otherwise have no chance of cashing in on the value created by urban expansion.

This is hardly revolutionary. Especially for Chongqing's Mao-loving party chief, Bo Xilai, doing good by the peasantry would seem a canny move. But because the notion of the collective persists, the system is wide open to abuses. Local officials have considerable incentives to force farmers to give up housing land and move to more compact dwellings in order to create land for *dipiao* trading (some of the proceeds of which also go to village authorities). The *dipiao* markets in Chongqing and Chengdu have done little more than add a layer of complexity to a widespread trend in many parts of China that has often added to peasants' grievances.

In the name of building a "new socialist countryside" (a slogan launched in 2005), local governments have been corralling farmers into new apartment blocks in order to free up land which they can use for profitable purposes. Officials have justified the practice as a way of reducing incentives for local governments forcibly to appropriate farmland and sell it to developers. Two million peasants a year have lost their land this way in the past five years, a senior government adviser in north-east China said in March. The new strategy often means the farmers are crammed into apartments with no backyards to raise chickens or store tools, and they face a longer journey to their fields.

Though officially sanctioned, the *dipiao* markets are viewed warily by the central leadership. Late last year Chengdu's market was suddenly closed down. No clear explanation was given, but a Chinese scholar says higher-level officials worried that *dipiao* were being traded without land having first been converted to agricultural use. The risk, central officials feared, was that it would never happen at all. The market reopened in April, but the central government remains cautious. In Chongqing only 10% of the government's annual sales of undeveloped rural land are subject to the *dipiao* system.

Thoroughgoing land reform, of the sort that would enable farmers to cash in on the value of their farmland and establish permanent and prosperous lives in cities (and at the same time encourage larger-scale farming), thus remains stuck. One obstacle is ideological: for all their economic pragmatism, many in the party still regard collectivism as a sacred principle. Privatisation remains a dirty word. A more practical worry is that reform might quickly be exploited by the very forces it is meant to constrain: rapacious local governments and developers. These, it is feared, would take advantage of any changes to persuade farmers unaware of land values to sell their holdings at less than market rates. The numbers of poor, landless peasants would soar, creating huge instability.

Reformers in Beijing argue that most farmers are far cannier than officials suspect. But the global financial crisis has strengthened the case for caution in the minds of party leaders. As many as 20m workers returned to the countryside when the crisis broke in 2008 and China's exports slumped. Having farmland to go back to, many officials believe, kept the unemployed migrants from taking to the streets. As officials often say in China, "stability trumps everything."

Prospects for reform of the *hukou* system are only slightly better. Both Chengdu and Chongqing have been experimenting with this. They have declared that holders of rural *hukou* in the countryside surrounding these cities can move into urban areas and enjoy the same welfare benefits as their urban counterparts without giving up their land entitlements. This was an important step. Though the *hukou* divide is widely resented, peasants have often been reluctant to give up their rural status for fear of losing their land, as well as the added benefit in the countryside of being able to have two children rather than one. In effect, Chongqing and Chengdu have created a new class of urban residents who enjoy the best of both worlds. But grand plans for *hukou* reform have fallen by the wayside before as officials tot up the price. The cities of Guangzhou and Zhengzhou abandoned reform efforts several years ago because of worries about the cost.

Chongqing's plans are ambitious. Local officials estimate the cost of converting 3m people at around 200 billion yuan ($30 billion). But the municipality says it wants to double the number of urban *hukou* holders by turning 10m of its rural citizens (some of whom already live in urban areas) into card-carrying urbanites over the next ten years. It has made a rapid start. Since it relaxed its policy in August last year it has given urban *hukou* to more than 1.7m people. There are conditions: they must have been working in urban areas for at least three years, or for five years if they want to transfer their *hukou* to the centre of Chongqing.

The reform remains only partial. The benefits of being a Chongqing urbanite still cannot be transferred to any other part of the country. And if implementing such measures nationwide means raising more taxes, urbanites will dig in their heels. Local governments "don't really have the incentives and they don't have the resources" to encourage greater integration of migrants into urban life, says the World Bank's Mr Kuijs.

Although Chinese officials define the population as being already nearly 50% urban, the number of urban *hukou* holders is only around 35%. Zhang Zheng of Peking University says many of those who have moved to urban areas in recent years are wrongly seen as permanent migrants. Having reached their 30s or 40s, when they can no longer do mind-numbing, fast-paced and finicky work on production lines, they will often go back to the countryside. Late last year the National Bureau of Statistics asked rural *hukou* holders in the north-eastern province of Jilin whether they wanted to switch to urban status. "The results were surprising," one of the bureau's researchers wrote. The majority said no, and most young people who had moved to urban areas said they wanted to go back to the countryside when they got older.

For the past two decades or more, urbanisation in China has come relatively easily. As the country proudly claims, slums and shantytowns are rare compared with other developing countries. But ensuring a continuing net inflow of migrants into the cities as the youngest cohort shrinks will mean giving workers from the countryside more incentives to stay permanently (such as affordable housing and schooling). More money is being spent on these, but not yet enough. Too much responsibility is devolved to local governments that usually try hard to shirk it.

Cities say they welcome migrants, but some find roundabout ways of keeping them from settling. Beijing recently launched a set of extraordinary measures to tame property prices and ease traffic congestion that included all but banning migrants (one-third of the city's population) from buying homes or cars. In the name of improving safety, it has started closing down basement dwellings where migrants (known as the rat tribe) often live. China says it wants urbanisation, and it certainly needs it. But even as some obstacles are removed, new ones spring up.

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Deng & Co

In both town and country, clans are as important as ever

YANTIAN IS STILL called a village, but these days it is an urban sprawl on the outskirts of Dongguan, a southern Chinese city famed for its labour-intensive factories and sleazy nightlife. Almost all of Yantian's inhabitants are migrants from other villages: young men and women whose toil helped create an industrial boomtown in a former expanse of paddyfields. As migrants, almost all of them are in effect shut out from the best schools and hospitals, as they are from local politics. Yantian is ruled by the Deng clan.

Critics of the *hukou* system often see it as a form of discrimination against people from rural areas by a privileged class of urbanites. But it is a problem for migrants of any kind: from big city to big city, from smaller towns to bigger ones or, as for most of Yantian's residents, from village to village. The OECD noted in a report last year that wage differences between cities in the same Chinese province are much bigger than in OECD countries. It said this was due to distortions in the labour market caused by barriers to migration between cities, not just between rural and urban areas.

In Yantian, the "real" villagers are those who lived there before it began its industrial transformation a couple of decades ago. The descendants of such people, no matter where they are born, are also included. As is common in rural China, most of Yantian's original inhabitants belonged to one clan, in this case the Dengs. Today there are 3,000-odd of them, out of a population of around 100,000. They enjoy the dividends of Yantian's wealth in the form of land rent: tens of thousands of yuan per person a year. A Deng can live a comfortable life on that without lifting a finger. Every factory has to appoint a recognised Yantian villager as a "manager" to handle liaison with local officials, so there are plenty of sinecures for Dengs who want them.

The Dengs have celebrated their fortune by building themselves a grand ancestral shrine on a hillside overlooking the village. The ornate complex, opened in 2005, includes a pavilion dedicated to Deng Xiaoping who they claim was descended from another branch that linked with theirs half a millennium ago.

Chinese officials like to boast that the country is developing village-level democracy. The law was changed last year to allow migrants to vote in their adopted home, but the village still has to agree. The Dengs have not. So it was no surprise that when the Deng who had been village chief for 30 years stepped down in April, he was replaced by another Deng.

Hereditary city-dwellers often pour scorn on rural clannishness, but Chinese cities are in some ways Yantians writ large. Urban Chinese are just as reluctant as the Dengs to share their wealth more widely.

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Government's role in industry

The long arm of the state

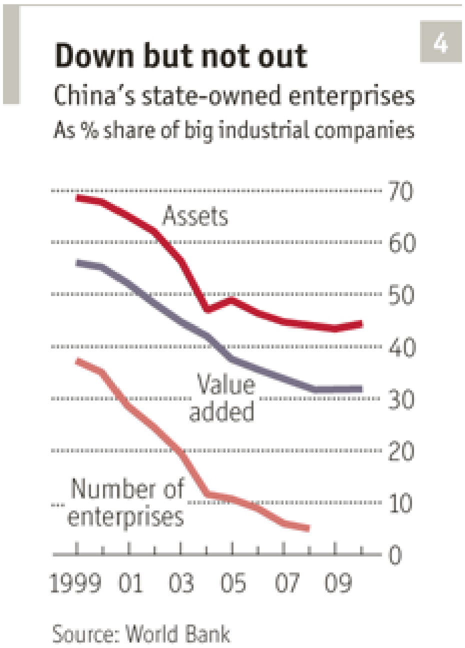
The government is flexing its muscles in business

Himin got a leg-up

ONE OF THE privileges that urban *hukou* holders enjoy is access to jobs in the state sector in the cities where they were born. In the late 1990s such work might have sounded precarious as China closed down or sold off thousands of state-owned enterprises (SOEs), throwing millions out of work. But those SOEs that remain are giants: 121 controlled directly by the central government and thousands of others run by lower-level authorities. Chinese students used to aspire to a job with a foreign company. Now they are more likely to want one with an SOE.

This may seem an odd choice, since the dynamism in China's economy is mostly generated by non-state firms. From 1999 to 2009 the state's share of industrial output by value fell from 49% to 27%, according to a recent report by Unirule Institute of Economics, an independent think-tank in Beijing. In 1999 government-controlled firms owned 67% of industrial capital; a decade later their share had fallen to 41%. But in the industries that pay the highest salaries, state firms dominate.

A new shorthand has entered common parlance: *guojin mintui*, meaning the state [sector] advances and the private retreats. It seems to suggest that the state sector's share of the economy is growing, which it is not; non-state businesses are in fact prospering. But the government has been muscling in on business in a variety of ways. It has been tightening its grip on some industries it considers "strategic", from oil and coal to telecommunications and transport equipment. It has been devising market-access rules that favour state firms. And to the chagrin of private businesses, it has allowed state companies to remain active in a surprising range of palpably non-strategic sectors, from textiles and papermaking to catering. In recent years property development has become a lucrative sideline for government businesses. "The tentacles of state-owned enterprises extend into every nook where profit can be made," writes Zheng Yongnian of the National University of Singapore.



Of 42 mainland Chinese companies in the *Fortune* 500 list of the world's biggest firms in 2010, all but three were owned by the government. Carl Walter, a Beijing-based investment banker, said in a recent book that getting as many companies as possible into that select group was a matter of deliberate policy. China's own list of the 500 biggest Chinese companies spans 75 industries. In 29 of these not a single private firm makes the grade and in ten others they play only a minor part. The government-owned enterprises in these 39 state-dominated sectors control 85% of the total assets of all the 500 companies in the list, according to researchers from the China Enterprise Confederation which compiled it. In 2010, 75 of the confederation's list of the 100 biggest publicly traded Chinese firms were controlled by the government.

Some Chinese economists worry that the government's response to the global financial crisis will bolster state enterprises and their bad habits at a time when they urgently need reforming. As the confederation's researchers put it, much stimulus spending has involved "swapping from the left hand to the right hand": the state lending to the state. "We do not do privatisation," declared the head of China's parliament, Wu Bangguo, in March, ignoring the fact that China had done a lot of it only a few years earlier. In the banking sector, says Yao Yang of Peking University, the government has been increasing its dominance in the past couple of years. Many Chinese economists call for interest-rate reforms that would allow banks to offer higher returns on household deposits (real interest rates are often negative). But banks do not want to lose the profits they make from the wide spread between government-controlled deposit and lending rates.

Unirule noted that the profits of state-owned industrial companies had increased nearly fourfold between 2001 and 2009. But their average return on equity was less than 8.2%, whereas that of larger non-state industrial enterprises was 12.9%. Factor in the low cost of borrowing enjoyed by SOEs and their access to land at below-market prices, the report said, and their real return on equity between 2001 and 2009 was minus 1.47%. They are, in effect, destroying capital.

Not pulling their weight

There are far better uses for their excess profits. Homi Kharas and Geoffrey Gertz of the Brookings Institution, a think-tank in Washington, DC, argued in a book published last year that if state-enterprise profits were used to help the government reduce all workers' social-insurance contributions, which currently make up about 35% of the remuneration of those in formal jobs, "China's middle class, most of whom are salaried workers, would instantly grow." The government has been requiring state firms to pay dividends since 2008, but many Chinese complain they are not offering enough and the money is being used to help state enterprises. The highest rate, paid by the most profitable ones, including the telecommunications, energy and tobacco industries, is 15% of post-tax profits-still very low compared with payouts by state firms in other countries. Even some official media have joined in the state-enterprise-bashing. A commentary on a government news website said they had "not played a positive role in improving social harmony".

Some foreign businesspeople complain that market-opening measures initiated in the 1990s and early 2000s have run out of steam. Many saw China's accession to the WTO ten years ago as a great impetus for reform. But when the country reached the end of its transition period in 2006, its will faltered. Many foreign companies still report doing good business.

But especially since the global financial crisis, the government has been widely accused of twisting rules in favour of its state-owned or, sometimes, private-sector favourites. In a forthcoming book, "China's Regulatory State: A New Strategy for Globalisation", Roselyn Hsueh of Temple University says China's strategy of "economy-wide market liberalisation and sector-specific reregulation" has enabled the country to "retain an upper hand over foreign forces even in a more liberal environment".

Local governments sometimes play a decisive role in determining which firms succeed and which fail. Take Himin, a manufacturer of solar water heaters based in the city of Dezhou in the northern province of Shandong. Himin is a private company, but it is the local government's champion. Together Himin and the government have devised a branding strategy for Dezhou as China's "solar city". The government has helped Himin to grow by requiring apartment buildings to be equipped with solar water heaters and by subsidising solar-heated bathhouses in villages. This leg-up has been crucial. The firm says it is now the world's biggest manufacturer of solar heaters. In turn, Himin has been crucial to the success of Dezhou's leaders, who last year hosted a big international conference on solar energy-in a 200m yuan solar-powered conference centre built by Himin.

Himin knows how to curry favour. In 1998, before it became fashionable, it set up a party branch whose work so impressed the leadership in Beijing that a member of the ruling Politburo paid it a visit. Himin's rewards for good behaviour include a seat on the national legislature for Huang Ming, the company's founder. One of the party cell's benefits, says an official account, has been to establish a "channel for understanding the direction of [government] policy".

Innovation by all means

Far more worrying to foreign businesses is a more overt form of government intervention involving support for Chinese companies that develop new technologies and discrimination against their foreign competitors. Complaints about this began to surface five or six years ago but have been growing much louder in the past two years. James McGregor of APCO Worldwide, a consultancy, described the government's strategy in a report last year as a "massive and complicated plan" to turn China into a technology powerhouse by 2020 and a global leader by 2050. He said it was "steeped in suspicion of outsiders" and constituted "a blueprint for technology theft" on a large scale.

This scheme to encourage what the government calls "indigenous innovation" focuses on seven "strategic" industries, from alternative energy and low-carbon-emitting vehicles to information technology. *First Financial Daily*, a Chinese newspaper, reported that investments by these industries could amount to as much as $1.5 trillion over five years, of which the state is likely to contribute 5-15%. Mr McGregor says the scheme involves creating new Chinese technologies on the back of foreign ones supplied by companies eager for a share in the government's massive spending. Some Chinese scientists have complained about the likely waste involved in state-directed R&D, but the party loves big projects too much to listen.

Foreign businesses in China have fought most bitterly over a new government procurement policy, launched in 2009, that favours products listed in catalogues of "indigenous innovation" technologies. They feared that the new regulations would shut them out of a multi-billion-dollar market. Under considerable international pressure from Western governments, Chinese leaders relented, promising that products supplied by foreign-invested firms in China would be treated like those of Chinese businesses. But in a recent report the American Chamber of Commerce in Beijing said several regulations still needed to be changed before these pledges could be implemented. In a survey a quarter of its members said they were already losing business because of "indigenous innovation" policies and 40% expected business to suffer in the future. Most of the American high-tech companies in China covered by the survey expressed concern.

China's state-sector reforms in the 1990s went for the low-hanging fruit. A decade ago angry workers were easily cowed into submission by police or bought off with handouts. But any further reform would affect the interests of people in the top echelons of the party as well as their families, who have extensive connections with state-owned firms.

Zhu Rongji, the former prime minister whose reforms obliterated many of China's state-owned firms in the late 1990s, has also gone on the attack. In April he made a rare public appearance at his alma mater, Tsinghua University. He handed over copies of a four-volume collection of his speeches, due to be published later this year, and pointedly invited readers to "make comparisons with the situation today". To his supporters, the present looks grim.

Demography

Getting on

The consequences of an ageing population

THE CLIENTELE OF the Le Amor retirement home in the Fragrant Hills of western Beijing are no ordinary folk. Staff boast that one of them taught President Hu Jintao when he was at university. Another is the descendant of a nutritionist who worked for the Empress Dowager Cixi, China's last great imperial ruler. A third is a former senior official in the party's top anti-corruption body. By the grim standards of such homes in China, it seems they are being treated well. If they wish, they can rent a suite of rooms, including one for a live-in servant. All rooms have an emergency button.

The home's director is coy about how she secured such a desirable rural location for her $10m venture, away from the city's downtown smog. Le Amor is one of only a handful of privately run retirement homes in the capital aimed at the well-to-do. Looking after the elderly is a business in its infancy in China, where that task usually falls to the offspring, if any. But Le Amor's market has very attractive prospects.

Over the next few years China will undergo a huge demographic shift. The share of people over 60 in the total population will increase from 12.5% in 2010 to 20% in 2020. By 2030 their number will double from today's 178m. The dependency ratio-the number of people of non-working age, both young and old, as a proportion of those of working age-will bottom out between 2012 and 2015 at an exceptionally low level before rebounding, says a report by the Chinese Academy of Social Sciences. Put another way, China's "demographic dividend"-the availability of lots of young workers-which helped fuel its growth will soon begin to disappear. The overall population will start to grow faster than that of working age. One trigger for this could be a sharp economic slowdown. Many Chinese have recently become familiar with the "Lewis turning point", named after a 20th-century economist from St Lucia, Arthur Lewis, who said that industrial wages start to rise quickly when a country's rural labour surplus dries up.

Watching the dependency ratio grow

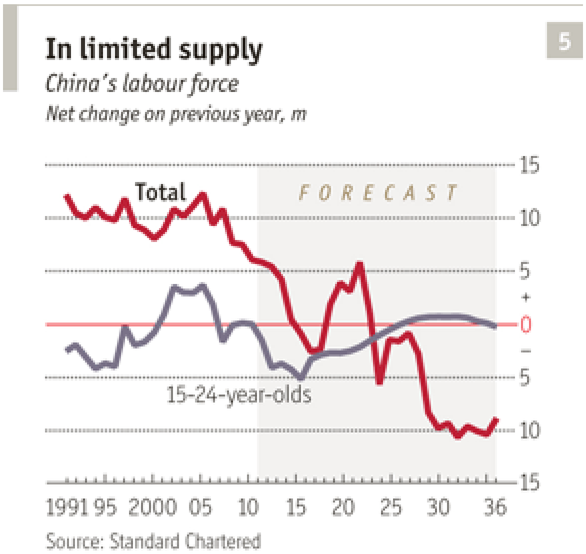
One way this will show up is in a proliferation of places like Le Amor. A lot of schools will close down. Wang Feng of the Brookings Institution notes that China's primary-school enrolment dropped from 25.3m in 1995 to 16.7m in 2008. Revoking the one-child policy would probably not make a big difference. Chinese couples have small families mainly because children are expensive, Mr Wang argues. China's rapid ageing, combined with a shrinking labour force, will "fundamentally reshape the Chinese economy and society", he suggests. In the next decade the number of people aged 20-24 will drop by 50%, Mr Wang predicts.

Optimists believe China still has several more years before the economic impact of an ageing population becomes apparent. China's commerce minister, Chen Deming, said in March 2010 that the country could still enjoy another decade of "demographic dividends". In a report last year Morgan Stanley pointed to 80m-100m surplus labourers in the countryside who could be employed in urban areas (although as this special report has argued, that might not be easy). It also expressed optimism about continuing productivity gains from rising levels of education and technology use.

In search of cheap young workers

Still, the redrawing of China's economic map is unmistakable. A decade ago, impoverished migrants gathered outside factories in cities like Dongguan, desperate for work. Now Dongguan's streets are full of banners and notices advertising jobs. Wage rises are beginning to accelerate. According to Stephen Green of Standard Chartered, they have risen by 9-15% this year in the Pearl River Delta around Dongguan. Part of the increase is government-driven. Local authorities have been raising minimum wages, and the new five-year plan calls for increases averaging 13% annually, nearly twice as fast as the target for GDP growth. But the main reason is a diminishing labour supply, helped in the delta by an uptick in labour activism. A local academic says that a strike at a Honda car-parts factory last year provoked more than 200 copycat strikes and protests.

Manufacturing is beginning to move inland to areas where labour is more plentiful and cheaper. Chongqing has been a big beneficiary. Morgan Stanley says the city is turning into the largest laptop manufacturing base in Asia. Its electronics industry is expected to create hundreds of thousands of jobs. Foreigners invested $6.3 billion in Chongqing in 2010, up by 58% on the year before.



Meanwhile, local governments across the country will have to cope with a fast-rising population of retired people whose pensions, if any, will have to be paid for by contributions from a shrinking working population. The central government has been trying to help, introducing a rural pension scheme that is due to cover the whole of the countryside by 2020. In rural areas the dependency ratio will rise far more steeply than in cities as young people move out and the elderly stay behind. But again money is a problem. As with schools and medical services, the central government makes the plans but leaves it to local governments to put up the lion's share of funding.

In the cities decent pensions are almost as rare, except among workers in the privileged state sector. In 2008 only 17% of migrants in urban areas were enrolled in any pension scheme at all, the government admits. Young urban couples, many of them without siblings, will find themselves with four parents to look after and will themselves have only one child (known as the 4-2-1 phenomenon). If they are sensible, they will save hard to prepare for such a future, which will not help the government's efforts to shift China towards more consumption-led growth.

A big increase in the retirement age is overdue. In practice this is now around 56. But the official age of 60 for men and 50 for women (55 for civil servants) has not changed since 1951, when average life expectancy was 46 compared with today's 73. Like their counterparts in the West, many workers groan about having to plod on for longer. Online polls, which are likely to reflect the views of younger people, have found strong opposition to any rise in the retirement age. Many fear that it could make it even harder for university graduates to find jobs (last year 6.3m students graduated from Chinese universities, up from 1m in 1999, so competition is fierce). When French workers went on strike last year over plans to raise their retirement age, officials in China hastily denied reports that they were planning to do anything of the sort. The people's will is almost as much of an obstacle to reform in China as the party's.

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Ideological battles

Universalists v exceptionalists

A mighty contest whose outcome will determine China's future

FOR A PRINCELING and former chairman of a state-owned company, Qin Xiao is far from typical. Instead of retiring quietly or taking up a party-funded sinecure, the gaunt one-time apparatchik has emerged in recent months as the standard-bearer of a liberal force in Chinese politics that refuses to be subdued by chest-thumping supporters of the "China model". He believes there is no such thing, only "universal values".

Mr Qin caused a stir in July last year when, in a speech at one of China's most prestigious universities, Tsinghua, he accused the China modelists of trying to replace enlightenment values of democracy, freedom and individual rights with "Chinese" ones, such as stability and the interests of the state. He was then very close to retiring from China Merchants Group, where he had held a job of ministerial rank bestowed on him by the party leadership. Since then he has not kept quiet.

Mr Qin continues to head a think-tank, the Boyuan Foundation, which he set up in 2007 along with He Di, an investment banker, who is also from one of the party's blue-blooded families. "China needs someone to stand up and speak," Mr Qin said in an interview published in May by an outspoken newspaper in Guangdong Province, *Southern People Weekly*. The Arab revolutions showed that no matter how well a country's economy performed, "people do not accept dictatorial, corrupt government." He is not alone in elite circles in expressing such views. Wang Changjiang, a senior scholar at the party's top training academy for cadres, lamented in December that there was a "phobia of political reform" in China.

In recent months the battle lines in China's politics have become clearer. They are drawn between universalists, who believe China must eventually converge on democratic norms, and exceptionalists, who believe that China must preserve and perfect its authoritarianism. For now the second group has the far stronger hand. The views of people like Mr Qin surface occasionally in China's handful of liberal newspapers, but hardliners in the party's mighty publicity department ensure that most media stick to a more conservative line. Remarks made by the prime minister, Mr Wen, last summer on the importance of (ill-defined) political reform were downplayed by mainstream newspapers in Beijing. Mr Wen is one of very few Chinese leaders who have clearly spoken in favour of the idea of universal values.

Liberals are particularly worried that the exceptionalist camp is also attracting the most ardent nationalists, who often claim that the West is trying to undermine China's achievements and keep the country from its rightful place as a great power. Zhang Weiwei, a scholar and proponent of Chinese exceptionalism, wrote in March that China's evolution was "as if the Roman empire had never collapsed and had survived to this day, turning itself into a modern state with a central

government and modern economy, combining all sorts of traditional cultures into one body and with everyone speaking Latin."

David Kelly at Sydney's University of Technology says the vocal nationalist left is having a similar effect on China's Communist Party as America's tea-party movement is having on the Republican Party: pushing it towards inward-looking conservatism. Statism is becoming the new ideological fashion, emphasising the paramount interests of the nation over the individual and the importance of government in guiding the economy. But many Western officials privately worry about the effect on China's behaviour of a confluence of nationalism, rapidly growing military capability and deeply held feelings of victimhood. Chinese diplomats continue to stress the importance of a "harmonious world" and decry the use of military force to resolve disputes. But in the past couple of years ascendant hardliners have pushed the foreign ministry, which had been relatively weak at the best of times, to adopt a more assertive, sometimes aggressive, posture. David Shambaugh, an American scholar, wrote in the *Washington Quarterly* that 2009 and 2010 "will be remembered as the years in which China became difficult for the world to deal with".

Don't pull the dragon's tail

This prickliness is partly explained by political uncertainty in the build-up to the leadership transition. No Chinese official who aspires to the top would want to be seen as weak in the face of any foreign slight. If China's economy begins to sputter in the coming years, the country's leaders will be all the more tempted to play to the nationalist gallery.

The Americans draw comfort from the fact that at least Taiwan has receded as a possible target of this. China has been more relaxed about the island since the election of a China-friendly president, Ma Ying-jeou, in 2008. Mr Ma and his Kuomintang party face fresh presidential and parliamentary elections on January 14th next year, but the opposition still has a lot of catching up to do.

A senior Chinese official compares China to Yao Ming, a basketball player and one of the country's most famous sporting heroes, when he was a teenager. At the age of 15 he was taller than everyone else, she says, but he was still only 15. Likewise, China is still maturing as a power and learning to cope with the world's rapidly growing expectations of it. This is an endearing image, but China has a problem that never troubled Yao Ming: a brooding animosity towards competitors that erupts occasionally into self-destructive rage. Spats last year with Japan and South-East Asian countries over maritime territorial issues badly tarnished China's image in the region.

As China becomes ever more engaged with the rest of the world, dealing with problems ranging from climate change to piracy and global financial security, the message it still conveys to its own people is that the West is implacably hostile to the country's rise. A Chinese patriot, the party is saying, must always be on guard against Western efforts to break up the country.

Here we go again

Such thinking is in abundant evidence at the National Museum overlooking Tiananmen Square. After a refurbishment lasting more than three years and costing some 2.5 billion yuan, the museum reopened in March to much fanfare. But one of its main attractions, an exhibition called "The Road to Rejuvenation", suggests that although the packaging is new, the content is much the same as before. What the party is telling its citizens is that the country is still recovering from the terrible wrong wrought by one-time imperialist powers.

The visitor walks through room after room recalling the depravities of foreign invaders in the 19th and 20th centuries who, as one notice puts it, "descended on China like a swarm of bees, looting our treasures and killing our people". There is a giant picture of Japanese troops butchering civilians in north-east China in 1894, painted two years ago; a large map that lights up to show areas under foreign domination in the 19th century; and a section called "cultural invasion and pillage".

There are huge gaps in the exhibition's coverage of the Mao period, when tens of millions died of hunger and millions from political persecution. It does not mention the Tiananmen upheaval of 1989 in which security forces killed hundreds, perhaps thousands. Instead, the visitor moves into a huge room brimming with cold-war imagery: China's accomplishments in space, its Olympic successes and a diorama of military hardware with a video display of marching troops.

Such ossified official thinking contrasts with a lively debate among Chinese intellectuals about where the country should be heading. In books, articles and blogs, some say that an era in the post-Mao history of China has ended. More than 30 years of reform, initiated by Deng Xiaoping, have transformed the country both economically and socially. Now, they say, it is time to focus on the unfinished business, that of transforming the country's politics. Deng himself stressed the importance of political reform, but the Tiananmen Square protests put an end to any prospects of taking it further. Given a fast-growing middle class, many liberal scholars argue, the country cannot afford to put it off any longer.

Many Chinese fret that any move towards more democracy would be doomed to failure because a politically empowered peasantry would simply make a mess of it. It is also often argued that democracy and Chineseness do not mix. The bloody mayhem of the Cultural Revolution is held up as an example of what can go wrong. China's leaders insist that political reform is still on the agenda. They point to some recent movement: occasional consultations with the public over the drafting of laws, a bit more openness about government budgets, and experiments with reform inside the party itself to allow a modicum of democracy in the selection of lowest-tier party officials. There is little sign that the new middle class is aching for more just yet.

But the next few years could see that middle class becoming more demanding. The internet will play a big role in this. The outgoing leadership has tried to tame it, but it remains a powerful tool for the disaffected in China, helping them to mobilise and share their grievances. One trigger could be a sharp economic slowdown. But even if the pace of growth eases gently, as many predict it will, the government will find itself under growing pressure from the less well off to distribute wealth more effectively.

That will require new taxes. One of these could well be a levy on property. Chongqing and Shanghai have recently begun very cautious experiments with such a tax, aimed in part at reducing local governments' dependence on money raised by taking land from peasants. But so far it affects only a tiny number of people in these places. A property levy on a broad swathe of the middle class would stir demands for a say in how their tax money is spent. For now the party would rather deal with angry underdogs than with an embittered bourgeoisie.

The tenure of China's outgoing leaders coincided with the rapid emergence of a new property-owning class that had barely existed until the late 1990s. The new leaders who will begin to take over next year will have to grapple with the political consequences. Their preference is likely to be more of the same: granting economic concessions but ceding nothing on politics. This could well result in even greater instability if the economy were to run out of steam.

China's current leaders may not agree that this is yet a *shengshi*. But when they took over in 2002 they set themselves the task of building what sounded rather like one. By 2020, they said, China would become a "well-off society in an all-round way". Some of the economic targets they set were easy: quadrupling GDP from a 2000 baseline and, later, quadrupling GDP per person by 2020 (real GDP had grown 2.7 times in yuan and more than fourfold in dollars by 2010).

But there is a lot of hard work still to do on some of the political and environmental goals: "better" democracy at the grassroots and greater "harmony between man and nature". Democratic reform is on hold and the environment is a mess. The leadership has recently begun to talk about a new target: boosting public "happiness" rather than just GDP. In a decade fraught with economic and political perils in China, that will be the hardest goal of all to achieve.

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Offer to readers

Business and the law

Corporations and the court

America's Supreme Court is the most business-friendly for decades

"TODAY'S decision will undoubtedly make some wonder whether the Supreme Court has now decided that some corporations are too big to be held accountable," thundered Patrick Leahy, a Democratic senator, on June 20th. His ire was aroused by the court's decision to scotch a sex-discrimination lawsuit against Walmart, the world's biggest retailer. Like many on the left, Senator Leahy thinks that under Chief Justice John Roberts the court has an excessively pro-business bias.

This week's verdict affects 1.5m current or former employees who joined a class-action lawsuit against Walmart. (The lead plaintiff, Betty Dukes, is pictured above.) They claimed that Walmart systematically discriminates against women, citing statistical disparities in pay and promotions. Walmart retorted that it has rules against discrimination and enforces

them vigorously. Since decisions about hiring and promotion are taken locally, by thousands of store managers, Walmart argued that it was unjust to cram so many separate events into a single lawsuit.

The court sided unanimously with Walmart on one question, concerning back pay. On the broader question of whether the 1.5m women constituted a single class, the court's five conservatives said no. They have "little in common but their sex and this lawsuit", harrumphed Justice Antonin Scalia. The court's four liberals favoured sending the case back to a lower court to give the plaintiffs another chance to get their arguments straight.

The court's balance shifted in 2006, after George W. Bush picked John Roberts and Sam Alito (two conservatives) to replace William Rehnquist (a conservative) and Sandra Day O'Connor (a centrist). Since then, the kind of cases that the US Chamber of Commerce supports have been more likely to succeed. During 1994-2005, some 56% of the cases supported by the chamber and considered by the court succeeded; the success rate during 2006-10 was 68%. In 2009-10 the side supported by the chamber won in 13 of 16 cases, five of those by the slimmest of majorities (5-4).

A study by Lee Epstein, William Landes and Richard Posner, entitled "Is the Roberts Court Pro-Business?", drew similar conclusions. It found that the Supreme Court ruled in a pro-business fashion in 29% of cases under Chief Justice Earl Warren (who served from 1953 to 1969). Under Warren Burger (1969-86) the figure was 47%. Between 1986 and 2005, under Chief Justice Rehnquist, it was 51%. Under Chief Justice Roberts it has risen to 61%.

Some cases particularly irk the left (see table). In 2007 the court threw out a sex-discrimination case filed by Lilly Ledbetter, an employee of Goodyear, a tyre company, because more than 180 days had passed since the company allegedly favoured her male co-workers in pay decisions. Her supporters argued that each new pay cheque should count as a fresh act of discrimination. By a 5-4 majority, the court disagreed.

Corporate shill or check on frivolous lawsuits?

Selected pro-business Supreme Court verdicts

Case	Summary	Verdict (year)	Vote
Ledbetter v Goodyear Tire and Rubber	Are certain sex-discrimination claims subject to a tight statute of limitations?	Yes (2007)	5-4
Citizens United v Federal Election Commission	Do corporations and unions have free-speech rights during elections?	Yes (2010)	5-4
AT&T Mobility v Concepcion	Do federal rules favouring arbitration trump Californian rules making it harder?	Yes (2011)	5-4
Walmart v Dukes	Can 1.5m women sue Walmart for sex discrimination together?	No (2011)	5-4
American Electric Power v Connecticut	Should greenhouse gases be regulated by judges, rather than the Environmental Protection Agency?	No (2011)	8-0

Sources: US Supreme Court; *The Economist*

In another case, the court refused to allow mobile-phone customers to sue AT&T as a class, instead limiting them to using the firm's arbitration process. The place "is making it more and more difficult for Americans to have their day in court," fumes Mr Leahy, a former lawyer.

But is the court really guilty as charged? Clearly, it is less hostile to enterprise than the Warren court was. Still, it does not always let businesses win. On June 6th it unanimously threw out a lower court's decision that restricted the ability of investors to bring a "fraud on the market" lawsuit against Halliburton, an oil-services firm. In 2009 the court allowed a lawsuit to proceed against Wyeth, a drug firm, for not putting a clear enough warning label on a drug, though its label had been approved by the Food and Drug Administration.

Both decisions exposed businesses to more lawsuits. In the Wyeth case, the court's liberals were joined by Clarence Thomas, the most conservative justice, because he thought that state laws should trump federal regulations. "This stuff is far more complicated than the left's basic caricature," says James Copland of the Manhattan Institute, a conservative think-tank.

It is not so much that the court is pro-business; it is more that a majority of justices think there are too many lawsuits, argues Tom Goldstein of SCOTUSblog, a forum for learned discussion of the court. The upshot, since businesses are generally the targets of lawsuits, is that "they tend to do pretty well," he says.

Also, the federal government demands far more of business than it used to, which generates more disputes. "As late as 1965, there was no employment-discrimination litigation, no class actions for damages suits, no environmental law and no campaign-finance limitations," observes Richard Epstein, a legal scholar at the conservative Hoover Institution. Small wonder the court's caseload has changed.

This week's decision will make it harder to assemble class-action lawsuits. Companies are delighted, as are those who think America's lawsuit culture does more harm than good. Trial lawyers are aghast, as are Democratic senators and those who distrust big business more than they distrust lawyers. However, the fury of this week's debate will seem like a blip compared with the battle brewing over Barack Obama's health reforms, which will surely come before the court before long.

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European corporate governance

Cleaning the Augean tables

Corporate governance in continental Europe is improving rapidly

WHEN Cesare Geronzi took over as chairman of Generali, an insurer, last year, many investors shuddered. Mr Geronzi's past has long been under scrutiny: prosecutors demanded in March that he go to prison for his alleged role in the bankruptcy of Cirio, a food company, in 2003. As chairman of Generali he quickly announced a new strategy for the firm to expand in Latin America which its chief executive and board had not even discussed. The insurer, he argued, could invest in a controversial project to build a bridge to Sicily, which some people think might indirectly enrich the mafia.

So when directors revolted and Mr Geronzi unexpectedly resigned in April, many investors saw it as a good day for European corporate governance. Europe's companies are not as ill-governed as some of its countries, but investors have a

barrel full of justified gripes. One is the dominance of large shareholders; minority investors often lose out. Fortunately, thanks to a series of technical changes to voting rules, smaller shareholders are getting more say. Across continental Europe, regulatory changes and direct intervention by shareholders are bearing fruit.

Many continental European countries used to force shareholders to hold on to their shares right up until a company's annual meeting if they wanted to vote at it. This dissuaded many funds from voting. However, a 2007 European Commission directive now means that in most countries shareholders can vote at a meeting as long as they owned the shares on a specified date two weeks beforehand.

Italy made the change last year. Many more institutional shareholders are already voting as a result. At Telecom Italia in April, minority shareholders put forward a list of alternative directors, which won 20% of the votes. That nearly matched the weight of the small clan of big, mostly local shareholders that in effect control Telecom Italia with only 22.5% of its shares. "It was an unheard-of level of support from big investors," says Gianfranco Gianfrate of Hermes, a British activist fund. The notorious power of Italian corporate cabals could be trimmed as a result.

Shareholders have cause to throw their weight around. They are under more pressure than ever to engage with companies, says Jean-Nicolas Caprasse, the director of ISS Europe, which advises them on how to vote. Britain has a tough new stewardship code for institutional investors, and the European Fund and Asset Management Association has just published similar rules. Protest votes everywhere are getting bigger. At TNT, a Dutch postal operator, shareholders won a battle to get the firm to separate its express business from its mail division, but the company added unpopular anti-takeover mechanisms to the express part. At its May annual meeting fully 60% of shareholders joined a vote of no confidence in the board. Hitherto, such defeats have been rare.

Minority investors have seldom howled as loudly as in 2008 when Porsche, a German car firm, announced that it had openly bought 43% of the shares of Volkswagen, another manufacturer, and a further 32% secretly through derivative contracts. Hidden ownership presents several problems. Buyers can build up a secret stake without paying a premium to smaller shareholders. Several cases in Germany have damaged the German stockmarket's reputation. A new law this year will oblige companies to disclose any potential ownership of voting shares via derivatives or other instruments. In France,

too, minority shareholders were enraged when LVMH, a luxury-goods firm, secretly seized a 17% stake in Hermes, a rival, using derivatives. This month the stockmarket regulator demanded new disclosure rules.

Southern Europe attracts the most scorn for poor corporate governance. But change is afoot. Italy now requires independent board members to veto any transaction which appears to benefit blocking shareholders rather than the company itself. Spain has abolished voting caps, which used to allow firms to limit outside shareholders to as little as a tenth of voting rights, regardless of how many shares they owned. Such caps deterred investment.

Excessive pay for managers angers shareholders most of all. Increasingly, they are vetoing it. Say-on-pay rules, which allow shareholders a vote on pay-and-perk packages, are spreading across continental Europe. In 2005, says Hans Hirt of Hermes (the fund, not the scarfmaker), German companies and regulators told him he was crazy to recommend the practice. Germany introduced a say-on-pay recommendation in 2009. Last year most German firms gave shareholders a vote. A north-south divide persists: most southern European firms don't want investors to question managers' pay. But disclosure has improved everywhere, says Stephane Voisin, a corporate-governance analyst at CA Cheuvreux, a broker in Paris. Three years ago, he says, a third of European firms properly disclosed pay packages for senior executives; now about 60% do.

Huge problems remain. A controversial recent trend is for continental firms to recombine the roles of chief executive and chairman (Carrefour this week became the latest example). In Britain the share of companies where the chairman and chief executive are the same person fell from 5.2% in 2007 to 1.5% in 2011, according to ISS Europe. On the continent the proportion rose from 10% in 2007 to 16% this year.

Succession is another flashpoint. When Reckitt Benckiser, a consumer-products group, announced the sudden exit of its long-serving boss in April, its shares dropped by 8%. Shareholders were furious at the lack of warning. At Deutsche Bank's annual meeting in May, investors similarly castigated management for failing to provide a clear succession plan for the bank's chief executive, Josef Ackermann. There is plenty left to do.

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The Bayreuth Wagner festival

GotterdÃ¤mmerung

The murky world of subsidised opera

We'll trade you tickets for decent costumes

GETTING a seat at the annual Bayreuth Festival of Richard Wagner's operas is about as easy as shaking off a dwarf's curse: the average waiting time is nine years. But things may change. On June 15th the Bundesrechnungshof, Germany's federal audit office, recommended that the festival, which gets over euro5m ($7.2m) a year of public money, should change the way it allocates tickets.

Only 40% are sold directly to the public-a mere 16% if it's a premiere. Murky quotas take care of the rest. The Society of Friends of Bayreuth gets 24% for its members. Around 30% go to such worthy causes as travel agents, who wrap them into hugely expensive tours, and corporate sponsors, for impressing (or perhaps intimidating) clients.

Sponsors must foster a long-term relationship to have a solid chance of ticket quotas, apparently. The process is far from transparent. The German Confederation of Trade Unions has one closed performance for its own big night out. Loyal trade unionists who are not Wagner fans (such people exist, believe it or not) have reportedly been able to sell their seats for a profit. There are moves to stop this practice.

Although ticket sales cover barely half the running costs-staging the end of the world is not cheap-the festival gives away 2,650 tickets a year to artists, its own staff, journalists and "special cases". That reduces even further the tickets available to Joe Public. Opera is great art, and part of Germany's heritage. But the state has no business subsidising corporate entertainment.

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Foreign law firms in Brazil

Keep out

Brazilian lawyers don't want pesky foreigners poaching their clients

WITH convicted criminals allowed multiple appeals and labour regulations that are a standing invitation to sue one's employers, you might have thought there would be plenty of work to go round for all the lawyers in Brazil. But behind the scenes some of the most powerful ones are agitating to make life harder for the 100 or so foreigners offering legal services in the country. Late last year the Sao Paulo chapter of the national bar association (OAB-SP) said that formal alliances between foreign-trained and local lawyers were against its rules. It confirmed that opinion in February. The federal bar association in Brasilia is now considering the matter. If it agrees, all formal local-foreign legal alliances may have to be dissolved.

Cross-jurisdictional legal work is strictly regulated. Foreign-qualified lawyers cannot work in firms that employ local ones or offer any advice on Brazilian law, even if they base their advice on that of a qualified Brazilian lawyer. But the OAB-SP's opinion went further. It proclaimed that alliances between foreign and Brazilian lawyers were unethical. "Foreign legal consultants", as foreign-qualified lawyers must call themselves, are not lawyers at all, it decided. That means Brazilian lawyers who make alliances with them are breaking the ban on multi-disciplinary work. It was the sort of convoluted reasoning of which any lawyer would be proud.

The pace of foreign law firms opening in Brazil has picked up. Before 2007 only five had offices there. Since then around three have opened each year, and a handful have signed formal accords with locals. The first of these, in 2001, between Linklaters and a medium-sized local firm, Lefosse Advogados, was looked at closely by the OAB-SP in 2006 and given the all-clear. Recent arrivals say they have done nothing different, and stayed within the rules.

They suspect that their real crime is to threaten a cosy status quo, in which a half-dozen big law firms advise on the Brazilian end of most big deals. With Brazil booming, that means fat and easy profits for incumbents. Medium-sized locals which have hooked up with foreign firms might challenge the oligopoly. "It's blatant protectionism," fumes one foreigner. Francisco Mussnich, a prominent local, put it pithily in an interview with *Latin Lawyer*, a trade publication. Asked about relaxing the restrictions on foreign firms, he said: "Brazil has great opportunities for sure-but you can't let the guy who wasn't invited to the party come in and steal all the sweets."

Foreign firms are also fuelling a red-hot jobs market for locals, at the expense of the old guard. The medium-sized firms associated with global giants are offering ambitious young lawyers higher pay and faster promotion. The regulators need to understand that a shake-up is in the interests of many locals, says one of those who decamped, adding: "In most of the big Brazilian firms the founding partners control everything. Young partners have no say in how they are run and a big chunk of what they generate goes to the senior partners."

How lawyers share out their whopping fees is of little interest to anyone but themselves. Clients care more about whether they get the best advice, and how much that advice will cost them. The ban on multi-jurisdictional law firms means that foreign companies setting up shop in Brazil, or Brazilian ones buying or merging with foreign ones, must seek legal advice from separate Brazilian and foreign firms. Their underwriters need the same again.

Opinions differ as to whether this matters. Rob Ellison, managing partner of Shearman & Sterling's Sao Paulo office, which has no formal accord with any Brazilian firm, says that the firm's clients are best served by its staying independent and working with whichever local is the best match for the matter in hand. Others say that some clients, at least, want multi-jurisdictional legal advice that is as seamless as possible-perhaps even more seamless than two firms with a formal accord can offer. "We have offices in 23 countries, and every week global clients ask us to act for them on cross-border transactions involving Brazil," says Anthony Oldfield of Clifford Chance's Brazil office. "We have to explain that we can do all the work in the other jurisdictions but not in Brazil."

In trying to make it harder for customers to get legal advice from formally allied firms, or even a global one-stop shop, Brazil is moving against a tide towards globalisation in legal practice. Singapore and South Korea both recently relaxed restrictions on multi-jurisdictional work. Only India is a hold-out, banning foreign lawyers on its soil from advising even on the law of their own countries.

There is a further twist to the tale. "The people behind this were battling on behalf of their clients to open up Brazil's economy to the world in the 1990s," says one disillusioned foreigner. "So it's ironic that now they're trying to protect their own turf."

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Entrepreneurs in Japan

Something must give

Japanese entrepreneurs are pressing for change. The old guard resists

Horie goes down in style

MORE than 100 days after the earthquake that hit Japan in March, 30,000 survivors still huddle in shelters, politicians have returned to their bickering and Japan Inc to business as usual. Two of Japan's most prominent entrepreneurs think this is not good enough.

The quake caused a nuclear disaster. So Masayoshi Son, the boss of Softbank, a big mobile operator, believes it is time to rethink Japan's dependence on nuclear power. He is talking to around 20 prefectures about building ten solar-power plants. Converting one-fifth of Japan's unused farmland to solar would generate 50 gigawatts, he says, which is equivalent to the peak output of TEPCO, Japan's largest electricity firm (and a quasi-monopoly).

Japan's old-guard businesses think this would be unnecessarily disruptive. And Mr Son's brashness annoys many. One boss calls him a "parasite" who must be eliminated.

Another young tech mogul has ruffled even more feathers. Hiroshi Mikitani, the founder of Rakuten, an online shopping mall that handles almost a third of Japanese e-commerce transactions, on June 23rd formally quit Keidanren, the club for big Japanese businesses. His gripe is that it opposes economic reforms, such as energy deregulation. "They want to protect old Japan," he says. This public snub undermines Keidanren's claim to speak for Japanese business with one voice. The old guard are spitting out their tea with fury.

Both men feel brave enough to stick their heads up because, as technology bosses, they do not rely on TEPCO the way other industrialists do. Mr Son also sniffs a commercial opportunity. He has always been bold and decisive: he took on the former telecoms monopoly and bought a bank during Japan's banking crisis a decade ago (though the business floundered). Mr Mikitani wants to reform Japan. "Most businesspeople fundamentally agree with me," he says, but they are afraid to say so publicly.

Yet the old Japan still has teeth. On June 20th Takafumi Horie, a young internet entrepreneur, was led away to serve a stiff prison sentence for accounting fraud. The founder of Livedoor, a web portal, was known for snubbing authority, making a hostile bid for a national broadcaster and standing for public office. Some fear that his sentence reflects his effrontery as well as his crime.

The oil-services industry

Rigging the market

Business is set to boom for the firms that help oil companies get at their prize

Harsh climes, big profits

WHEN the price of oil goes up, oil firms drill deeper. They also venture into harsher climes and seek out unconventional sources of oil and gas that, in happier times, would be too costly to extract. National oil companies (NOCs) often lack the skills to do any of this. The world's big independent oil firms struggle, too. So they turn to the oil-services industry, which is set for a gusher of profits.

Four big firms dominate the business of managing geological data, digging wells, building rigs, handling infrastructure and developing the technology needed for large projects. Baker Hughes and Halliburton have their headquarters in Texas, as did Weatherford, though it recently moved to low-tax Switzerland. Schlumberger, a French company with revenues of some $27.4 billion in 2010, also has a big office in the Lone Star State.

America is the centre of the boom, says James Crandell of Dahlman Rose & Co, a bank. Oil-services firms there pioneered the technique of horizontal drilling, which is used to extract shale gas from America's vast fields (conventional oil and gas are extracted using vertical wells). The same trick can be used to get at shale oil. As a result exploration and production (E&P) budgets in America are swelling.

There's more to come. Morgan Stanley, a bank, reckons that shale-oil production will increase nearly fivefold by 2016 (to around 1.9m barrels a day). This means a huge increase in the number of rigs supplied by the oil-services firms. The

logistical and technological challenges of unconventional oil and deepwater drilling, now getting back up to speed after the Deepwater Horizon disaster in the Gulf of Mexico, will also boost demand. The harder the oil is to extract, the bigger the rewards for the oil-service companies. Halliburton is gearing up by boosting its workforce of 60,000 by 25% this year.

The bonanza is not restricted to America (see article). Most oil that is cheap and easy to get at has been found. Fewer and smaller discoveries mean that oil companies are forced to spend more on E&P to get at unconventional shale oil, heavy oil and tar sands as well as sinking wells deep underwater. Dahlman Rose reckons that global exploration budgets will rise by some 14% in 2011, to $533 billion.

Oil-services firms have plenty of conventional work, too. Iraq is trying to boost its output. In March Saudi Arabia, keen to maintain a buffer of spare capacity, said that it planned to increase its rig count by 30% by some point next year. The Saudis are not alone in their desperation to stem the declining output of big and ageing oil fields. This means lots more spending on technologies to arrest decline rates and on maintenance to keep older wells around the world in tip-top condition.

By offering the full array of oil-field services, the big four have an advantage over smaller rivals. NOCs generally prefer to deal with one firm that can offer all the services they need rather than dealing with a crowd of different contractors. Mr Crandell reckons profits for the big four could nearly double over the next couple of years, as they wring oil and gas out of ever-more inaccessible places.

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Energy in Poland

Fracking heaven

Other Europeans fear fracking. Poland is steaming ahead

POLAND may have western Europe's largest reserves of shale gas. A dozen global gas-exploration companies have promised to drill as many as 120 test wells over the next few years to find out. The prize could be trillions of cubic metres of gas. It is "a huge and expensive gamble", says Tomasz Maj, the head of Polish operations for Talisman Energy, one of

the exploration firms. The rewards could be vast. Shale gas could free the country from its dependence on coal, a dirtier fuel, which currently accounts for 95% of Polish power generation. It could also mean that Poland no longer has to rely on Russia, the neighbourhood bully, for most of its natural gas.

But the extraction of shale gas is controversial. It requires fracking: blasting fissures in subterranean rock and pumping in water and sand, and occasionally nasty chemicals, to force out the gas. France won't do it. There is local resistance in the Netherlands. Yet other countries' qualms may make fracking more attractive for Poland. If others won't frack, they will probably buy Polish gas.

European energy policy is in turmoil. Germany decided last month to abandon nuclear energy. A referendum in Italy on June 12th also said "no thanks" to nuclear power. Reliable sources of energy are inadequate to meet future demand. Poland sees an opportunity.

"We'll never be an oil state, but we could become a Norway," says Andrzej Kozlowski of PKN Orlen, an oil company in which the government has a 28% stake. The Polish government is keen to attract firms with experience of fracking in North America, such as ExxonMobil and ConocoPhillips. It has awarded nearly 90 concessions so far. These are cheap, and production royalties will be low. But firms will be penalised if they fail to drill the promised test wells.

Oil-and-gas firms have been fracking on a large scale in Canada and America for over a decade. In May a delegation of Polish geologists and officials visited Canada to wise up on social and environmental as well as technical issues. The government is also taking advice from GFZ, a geological institute in Potsdam, Germany, and from demosEUROPA, a think-tank in Warsaw.

Fracking is a completely new industry for Poland, so the government is anxious to get the rules right. Taxes must be low enough to encourage investment, but high enough to raise revenues. Getting neutral advice on the environmental risks is not easy. Fracking can damage the water table, disrupt communities and even cause earthquakes. (In Britain on May 31st Cuadrilla Resources said it was halting a fracking operation near Blackpool, pending investigation of two small earth tremors which it may have triggered.)

The French government imposed a moratorium on fracking on May 11th. In Britain, by contrast, a parliamentary committee was friendly to fracking. EU law allows member states to exploit their natural resources as they see fit, but subject to minimum environmental standards. The European Commission is due to roll out its long-term energy strategy in November, which could affect fracking. But Poland, whose six-month presidency of the European Council begins in July, is in a good position to influence what it says. On June 21st Poland was the only EU member to vote against a proposed tightening of carbon-emissions targets for 2020.

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Schumpeter

The bottom of the pyramid

Businesses are learning to serve the growing number of hard-up Americans

MANAGEMENT gurus have rhapsodised about "the fortune at the bottom of the pyramid" in emerging markets ever since C.K. Prahalad popularised the idea in 2006. They have filled books with stories of cut-price Indian hospitals and Chinese firms that make $100 computers. But when it comes to the bottom of the pyramid in the rich world, the gurus lose interest.

This is understandable. McDonald's and Walmart do not have the same exotic ring as Aravind Eye Care and Tata Motors. The West's bottom-of-the-pyramid companies are an unglamorous bunch. Many rely on poorly educated shift workers. Some inhabit the nether world of loan sharks and bail bondsmen.

But even in one of the world's richest countries the hard-up represent a huge and growing market. The average American household saw its real income decline between 2005 and 2009. Millions of middle-class Americans have been forced to "downshift", as credit dries up and the costs of college and health care soar. Some 44m Americans live below the official poverty line ($21,954 a year for a family of four). Consumer spending per household fell by 2.8% in 2009, the first time it had fallen since the Bureau of Labour Statistics started gathering data in 1984.

This is a challenge to the American dream. But it is also an opportunity for clever companies. Even the poorest Americans are rich by the standards of many other countries, so there is money to be made by serving them. McDonald's, for example, is booming. Since 2006 its restaurants have generated an annual increase in sales of 4%, despite rising food prices. (This figure excludes restaurants that have been open for less than a year.) In April the firm hired an astonishing 50,000 full- and part-time staff in America, at a time when many others are shedding hands.

Frugal shops have been thriving, too. Walmart and Target are marching into new markets (such as basic medical care) and new places (such as inner cities). Aldi, a German discounter, has been doing surprisingly well in America, too. Unlike Walmart, it specialises in small stores-the size of a basketball court rather than a football pitch. More than 90% of its goods are its own unfancy brands. To keep its supply chain simple, Aldi stocks barely 1,000 products; some of its rivals stock 100,000. Yet Aldi is not a grotty place to shop. It has wide aisles and bright decorations, unlike some of the discount stores that disfigure American inner cities.

Aldi's success highlights an interesting fact: that there is a lot of innovation in this market. Companies are reconfiguring themselves to appeal to the *nouveaux pauvres* as well as the old poor: middle-class people who enjoy lattes and salads but who are currently strapped for cash. Walmart has vastly expanded its grocery section. McDonald's sells healthy fast food, such as fruit and walnut salad, as well as the usual slabs of meat and cheese in a bun. It also plans to remodel or rebuild 6,000 of its 14,000 American stores. And both McDonald's and Dunkin' Donuts are challenging Starbucks by offering drinkable coffee for less.

The rise of online pawn

Even that staple of the urban poor, the pawn shop, is being reinvented. Pawngo is putting pawn on the internet for the convenience of what it describes as "college-educated working professionals with temporary cashflow problems". Customers can send their college-graduation presents (for example) to Pawngo by FedEx and get a loan in the form of a bank transfer.

Entrepreneurs are also adjusting their business models to deal with the age of austerity. One popular model is paying for things upfront (which appeals to consumers who have poor credit or who want to curb their splurging). Pre-paid wireless providers such as Leap Wireless and MetroPCS have captured 90% of the growth in the market for mobile telephony. Houston's Direct Energy has just introduced a pre-paid plan for electricity. A second popular model is "collaborative consumption", which allows people to share or rent rather than own. Swap.com enables you to swap DVDs and videos with other sofa spuds. ThredUp does the same for children's clothes. Jobless students can hitch lifts via Craigslist (a website for classified ads), or doss down in someone else's flat via CouchSurfing, another website.

Adjusting to this new world can be hard. Companies have long assumed that America would always be a land of mass affluence and upward mobility. But the American economy was undergoing a structural shift even before the 2007 financial crisis, with galloping rewards at the top and stagnation for many of the rest. Some economists expect the malaise to last for years. Few companies have thought much about the implications of this.

Wireless companies blithely assume that everyone will soon have smartphones and broadband connections, just as everyone now has a car and a television. But their confidence is probably misplaced, argues a new report on "The Poverty Problem" by BernsteinResearch, a consultancy. Broadband penetration may have plateaued, at nearly two-thirds of households. Pay-TV penetration is beginning to decline.

The optimists' complacency creates opportunities for nimbler and gloomier competitors. It also creates an opening for companies from the emerging world, many of which have frugal innovation in their DNA. TracFone Wireless, a subsidiary of Carlos Slim's America Movil, has sold more than 3m phones in America since 2008 to pre-paying customers. MedicallHome, a Mexican company that provides medical advice over the phone for $5 a month, as well as access to its network of 6,000 doctors, is expanding north of the border. Emerging giants such as India's Tata and China's Haier regard America as a natural market for their frugal products. The bottom of the pyramid is wider than most people realise. Firms that offer ultra-low prices will find themselves as much in demand in Detroit as in Delhi.

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Exchange-traded funds

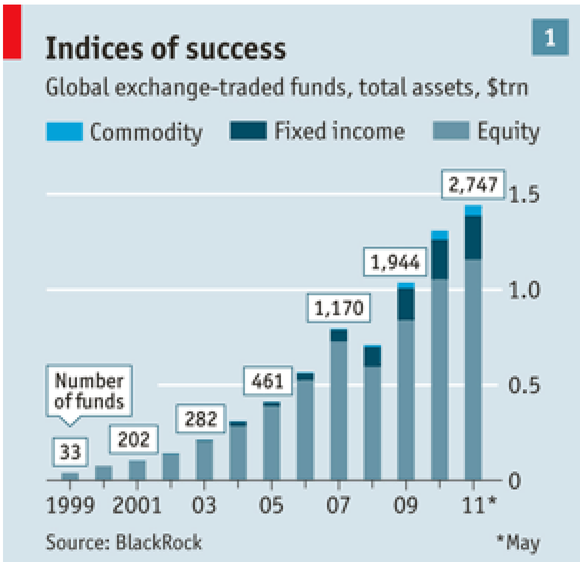
Too much of a good thing

The risks created by complicating a simple idea

ANY industry would be proud of an average annual growth rate of 34% over ten years and of a global reach from Austria to Taiwan. But the headlong expansion of exchange-traded funds (ETFs), which by May this year controlled almost $1.5 trillion of assets (not far short of the $2 trillion in hedge funds), has become a matter for concern among financial regulators. Could ETFs be the next source of financial scandal, or even of systemic risk?

ETFs have been around since 1990, when the first fund was launched in Canada. The original idea was to create portfolios of shares replicating a stockmarket index, such as the S&P 500. Index-tracking funds had been available to institutional investors since the 1970s. Companies such as Vanguard offered them to individuals in the form of mutual funds. However, as the name suggests, the key feature of an ETF was that it was itself listed on a stockmarket, so that investors could buy and sell it easily. Unlike units in a conventional mutual fund, ETFs can be traded all day long.

Most people still regard these plain-vanilla ETFs as a benign invention that allows small investors to own a diversified portfolio at a low cost. State Street's $88 billion SPDR fund, which mimics the S&P 500, has a total expense ratio of just 0.09%.



But fund managers quickly elaborated on the basic design. The number of ETFs has swelled to 2,747 (see chart 1). Within equities, there are ETFs based on small-cap companies, value shares, individual industries and every conceivable combination of countries and regions. In bonds, there are ETFs linked to government, corporate and high-yield debt and paper of varying maturities. Some ETFs are based on commodity indices and property markets, others are designed to appeal to the environmentally conscious or to devout Muslims. There are leveraged ETFs which offer a geared return on a

given index, inverse ETFs which aim to go down when a benchmark goes up (and vice versa) and, inevitably, leveraged inverse ETFs.

For some, this is a worrying trend, with echoes of the subprime housing crisis, in which financial innovation went out of control. That crisis, too, had its origins in invention with a benign aim: the packaging of mortgages for use as securities for bonds was intended to reduce borrowing costs and disperse risk. Eventually, however, that simple idea transmuted into complex collateralised debt obligations and lower lending standards.

Exotic traded funds

Similarly, the new types of ETF no longer offer the cheapness and diversification of the early varieties. Instead they have become a means for hedge funds to speculate on the market throughout the trading day, allowing them to make complex bets on illiquid asset classes. And the portfolios of some ETFs consist not of a broad range of stocks but of a derivative position with an investment bank as a counterparty.

Official concern is growing. In April three international bodies set out their worries. The Financial Stability Board (FSB), a committee of financial supervisors, issued a report on ETFs. The IMF devoted part of its global financial-stability report to them. And the Bank for International Settlements (BIS) published a paper entitled "Market Structures and Systemic Risks of Exchange-Traded Funds".

One risk is a lack of liquidity. On May 6th 2010 trading in the American stockmarket seemed to go haywire: the Dow Jones Industrial Average fell by almost 1,000 points in the session and some stocks lost almost all their value. This "flash crash" prompted the authorities to cancel a bunch of trades made at unusual prices. Between 60% and 70% of those trades were in ETFs, far above their actual weighting in the market.

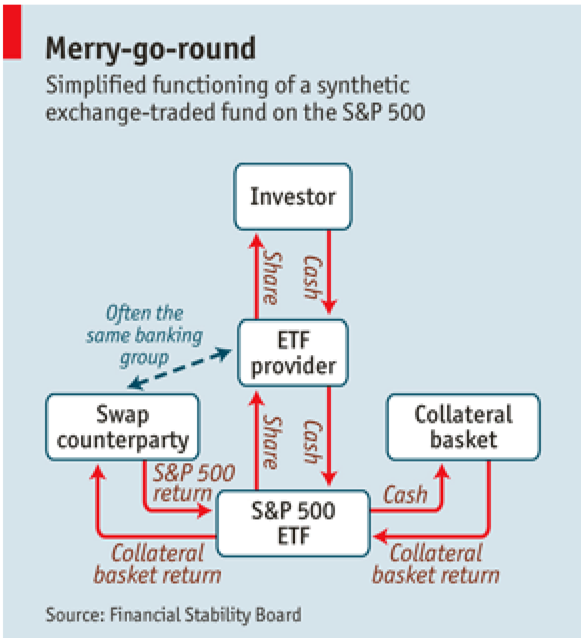
Some investors use ETFs as a quick way of expressing their overall view on the market, while high-frequency traders use the funds as part of their complex arbitrage strategies. But such strategies work only as long as there is someone willing to take the other side of the trade. In chaotic conditions, there may be sellers but no buyers. As the IMF points out, "While most ETFs are supported by one or two marketmakers, there is no guarantee of active trading under illiquid conditions."

A linked problem is the tendency for ETFs to be the main way in which investors seek exposure to some asset classes, notably gold. Once upon a time gold bulls had to pay a hefty markup to buy coins or had to purchase shares in gold-mining companies and hope that the management was competent. But gold ETFs have been hugely popular, seeing inflows of $12 billion in 2009 and $9 billion in 2010. The largest gold ETF holds more bullion than all the world's central banks except those of America, France, Germany and Italy. The IMF also has more. The surge of interest in gold ETFs has been encouraged by (and may have in turn contributed to) a rise in the bullion price. If investors lose faith, the market may become disorderly as they scramble to take their profits.

Some ETF managers also top up their income with fees for lending the securities in their portfolios. There is a risk that, in a period of market disruption when ETF investors want their money back, managers would be forced to recall such loans, adding to liquidity pressures.

Another problem lies in the existence of leveraged ETFs, where losses as well as profits can be magnified. Were a leveraged ETF to suffer huge losses, the reputation of the entire industry might be affected, particularly among private investors. Inverse ETFs offer a way for investors to bet on a fall in an asset class but they may not always deliver such a return over an extended period. "It isn't hard to give examples in which investors would lose money on a leveraged long ETF if the market went up over a period of significant volatility, or in which they lost money owning a short ETF and the market went down over a period in which there were some sharp rallies," says Terry Smith, chief executive of Tullett Prebon, a money broker.

Perhaps the biggest concern, and the one with the clearest echoes of the subprime crisis, surrounds "synthetic" ETFs and linked products known as exchange-traded notes (ETNs) and exchange-traded vehicles (ETVs). An ETN is a debt security issued by an index provider or a bank and traded on the market; an ETV is similar, but the debt issuer is a special-purpose vehicle. Collectively these offshoots are known as exchange-traded products (ETPs).



The rationale for concocting this alphabet soup is the desire to create funds linked to illiquid asset classes. It may be too costly or impractical to replicate the targeted index completely. To synthesise it, the ETF provider usually enters into a transaction known as a total return swap with a bank. The bank agrees to pay the provider an amount equal to the return on the chosen benchmark, say an emerging-markets index; the provider hands over cash in return. The bank now has to manage the risk of replicating the index; the provider faces the risk that the bank might go bust. So the ETF provider requires the bank to provide collateral (see diagram).

The financial laboratory revisited

Here's the rub. The collateral is usually unconnected with the index. The BIS cites the example of an emerging-markets ETF offered by a firm called db x-trackers. The collateral was in the form of equities and bonds. Most of it had nothing to do with emerging markets. Around half of the equity portion was in Japanese shares; another 30% consisted of American and German ones. Of the bonds, three-quarters were American, many of them unrated. Were the bank counterparty to fail, the index provider would be left with assets that were unrelated to the target portfolio.

Worse, the BIS points to a potential conflict of interest when the fund provider is owned by an investment bank. When a bank acts as a marketmaker, it needs to keep an inventory of bonds and stocks so that it can deal with clients' demands to buy and sell. These positions have to be funded, which can be costly, especially if the securities are illiquid. "By transferring these stocks and bonds as collateral assets to the ETF provider sponsored by the parent bank, the investment banking activities may benefit from reduced warehousing costs for these assets," the BIS warns.

That raises the danger that an ETF could act as a dumping ground for the unwanted securities on an investment bank's books. "The synthetic ETF creation process may be driven by the possibility for the bank to raise funding against an illiquid portfolio that cannot otherwise be financed," says the FSB report. Again, there are parallels with the subprime crisis, where mortgage-backed securities were warehoused in off-balance-sheet ventures.

If doubts emerged about the health of the bank involved in the swap, investors might be inclined to sell their holdings in the ETF or the ETN rather than take their chances on the exact value of the collateral. After all, as the crisis of 2008 showed, when banks are collapsing the value of all kinds of assets takes a battering.

The structure of synthetic ETFs is not a secret. Anyone who reads the documentation carefully should be aware of the nature of a fund and the type of collateral. It is also worth noting that in America these concerns apply only to ETNs and ETVs. In products labelled as ETFs, at least 80% of the portfolio must comprise securities matching the fund's name.

In Europe synthetic funds make up around half of the ETF sector by assets. However, the European Fund and Asset Management Association, a trade body, points out that the vast majority of them trade under the UCITS (Undertakings for Collective Investments in Transferable Securities) rules, which limit some of the risks outlined by the BIS and the FSB.

For example, rules on conflicts of interest restrict the choice of counterparties, a fund cannot have an exposure to any one counterparty that comprises more than 10% of its value, and the chosen collateral is subject to liquidity and credit-quality criteria.

Despite some eerie parallels, it is hard to conclude that ETFs yet pose a systemic risk on the same scale as mortgage-backed securities. Leveraged funds have around $40 billion of assets, less than 3% of the industry total, according to BlackRock, a fund-management group that, under its iShares brand, is the biggest provider of ETFs. Synthetic ETFs had more than $140 billion of assets in May. Though ETPs have been growing rapidly (see chart 2), their total value is less than $200 billion, less than one-seventh of that of conventional ETFs. It seems unlikely that banks have the same kind of exposure to collapsing ETFs as they did to the subprime market.

Nevertheless, the rapid trading of ETFs is an area of concern, especially when the underlying assets are illiquid. Creating a synthetic ETF does not eliminate this illiquidity risk, but merely transforms it into a bet on the creditworthiness of a bank. One day that bet will go wrong.

Even some in the industry are nervous about the profusion of new vehicles. A failure might diminish the appeal of ETFs as a whole. "There are products that are not even funds which are being called ETFs," reports Deborah Fuhr of BlackRock. "The risk of confusion, disappointment and disillusionment among investors would be very negative for the ETF industry."

That would be a shame. Fund managers' fees have always eaten into investors returns; ETFs were a splendid way of letting investors keep more of their money. But like a hyperactive child, the finance sector can never leave a good thing be.

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America's debt ceiling

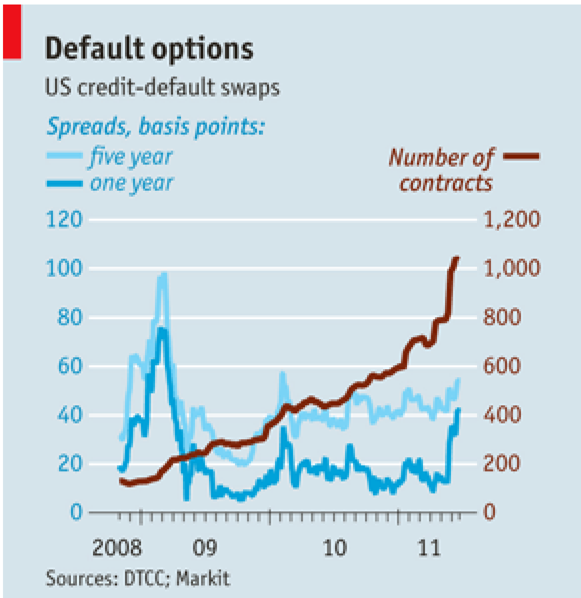
The mother of all tail risks

A US technical default would convulse markets. Nothing else is certain

AMERICA'S debt is supposedly the world's safest, backed by trustworthy courts and an unrivalled capacity to raise taxes and print money. Yet thanks to a quirk of law, talk of default is not confined to the European side of the Atlantic.

Unlike most countries America requires two legal steps to run a deficit: one to pass budget bills, the other to borrow the money. Congress sets a ceiling on how much the country may borrow. In the past it has always raised the ceiling before the Treasury ran out of cash, doing so on 16 occasions since 1993 alone. But it often attaches conditions, and this year Republicans who control the House of Representatives are insisting on particularly onerous terms. With the debt and the deficit at their highest in 60 years, they want to see at least $2 trillion in spending cuts over ten years and no tax increases.

If a deal cannot be reached before August 2nd the Treasury says it will be forced to default. It has not specified on what: it could choose to stop paying pensioners and soldiers before it stopped paying interest on its debt. But outright default cannot be entirely ruled out. What happens if the world's most trustworthy borrower reneges on its debt?



The possibility has not gone unnoticed. Trading in credit-default swaps (CDSs) on Treasury securities has picked up and the price of protection against default, as measured by the CDS spread, has risen (see chart). One-year protection is now almost as expensive as five-year protection. This is more often seen in distressed markets where investors are pricing in an imminent default than with otherwise healthy borrowers with long-term problems.

The illiquidity of the CDS market means it can be prone to misinterpretation. The vast Treasury market itself-for Treasury bills, Treasury bonds and other government securities-remains largely free of anxiety. America's biggest interest payments occur on the 15th of August, November, February and May. Priya Misra, head of US rates strategy at Bank of America Merrill Lynch, says anyone who thinks America might default for several weeks this summer should sell a bond with interest due on August 15th and buy one with interest due on November 15th, which would result in the price of the first bond falling relative to the second. But, she says, neither market pricing nor the chatter of clients shows such a trend.

There is a profound muddle about what a default would entail. Firms usually get a few weeks' grace to make a payment. Sovereigns typically do not so default would probably be declared the day the Treasury missed a payment.

Some market participants argue such a default would be quickly "cured" and be therefore merely technical. Yet history suggests that even a technical default can be costly. America's only known instance of outright default (other than refusing to repay debts in gold in 1933) occurred in 1979 when the Treasury failed to redeem $122m of Treasury bills on time. It blamed unprecedentedly high interest from small investors, a delay in raising the debt ceiling and a word-processing-equipment failure. Although it repaid the money and a penalty to boot, a later study by Terry Zivney, now of Ball State University, and Richard Marcus of the University of Wisconsin-Milwaukee found it caused a 60-basis-point interest-rate premium on some federal debt. Today that would cost $86 billion a year or 0.6% of GDP, a hefty penalty for something so avoidable.

A default now would attract more attention, affect more debtholders and reach more deeply into the financial system. More than half of Treasury debt is held abroad, principally by foreign central banks. Such investors would be unlikely to sell overnight since they have few ready alternatives. But they would be reluctant to hold as much in the future; some, like China, are already diversifying their reserves. After Fannie Mae and Freddie Mac, two giant mortgage-financing agencies, had to be rescued by the federal government in 2008, foreigners cut their holdings of these securities and have yet to raise them again even though the firms never defaulted.

Domestic banks would not have to classify their sizeable holdings of Treasuries as non-performing if they thought the default short-lived. But they would suffer nonetheless. Currently Treasuries represent roughly 30% of the collateral that financial institutions such as investment banks use to borrow in the $4 trillion repurchase ("repo") market. They represent another 4-5% of the $1 trillion in collateral used in the derivatives market. A default could trigger demands by lenders like money-market funds for more or different collateral.

Matthew Zames of JPMorgan Chase, writing on behalf of the securities industry in April, gave warning that this could "lead to deleveraging and a sharp drop in lending". Money-market funds themselves hold another $338 billion of Treasuries. In the event of a default at least one would probably "break the buck" (ie, fail to give the principal back to investors), threatening "a broader run on money funds", Mr Zames said.

No one can be sure of any of this. Money-market funds, like banks, might argue their holdings are sound if the default is brief. A suspension of new sales of bonds could constrict supply of Treasuries, pushing yields down instead of up. On the other hand America responded to the crisis of 2008 by standing behind the obligations of banks, money-market funds, and Fannie and Freddie. It could hardly do the same for a crisis caused by an inability to stand behind its own debts.

Even if Congress were to tackle turmoil by quickly lifting the debt ceiling, the stain would linger. "In the past our assumption was interest would always be paid on time," says Steven Hess of Moody's, a ratings agency which has cautioned that even a brief default would cost America its coveted Aaa status. "If an actual payment were missed once, might that happen again? If you thought it could, that is clearly not compatible with Aaa." Such warnings are having an effect. On June 19th Mitch McConnell, the Republicans' leader in the Senate, opened the way to a short-term increase in the debt ceiling, even though his counterparts in the House demurred. They may not show it but Republicans, like Democrats, are scared of default, too.

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Buttonwood

The return of rationing

The difficult decisions needed in an age of austerity

POLICYMAKERS must juggle three priorities when offering a public service: coverage, cost and choice. They almost always have to sacrifice at least one of the three. As austerity bites, this equation is going to lead to very tricky decisions.

Health is an area where the trilemma clearly applies. Britain's National Health Service offers universal coverage but as a result has to limit patient choice in order to control the costs. The American health system historically gave a high priority to patient choice at the price of ballooning costs and the exclusion of the uninsured from the system. Having increased coverage, the Obama reforms will have to restrict choice if they are to control costs.

Over the past 40 years cost has been less of a constraint in all areas of public policy than it might have been. At times of crisis governments without exchange-rate targets have been able to let their currency, rather than the real economy, take the strain. Steady growth has allowed governments to expand the services they offer. Once granted, a service or benefit is hard to remove because recipients campaign for its retention.

Pensions are a case in point. Governments have promised generous future benefits without recognising the full cost upfront. The demographic bulge caused by the baby-boomers helped at first: when the promises were made, the ratio of workers to retirees was high.

Now that the boomers themselves are retiring, the cost is becoming clear. On the issue of coverage, governments can hardly remove pension rights altogether. So they are having to ration the benefits. Rather than retiring earlier than private-sector employees and having their pensions linked to their final salaries, British public-sector workers are being asked to retire later, have their pensions based on a career average and enjoy less generous inflation-linking. This has provoked unions to call strikes for June 30th.

Britain is still in the relatively fortunate position of having an independent monetary policy and the ability to borrow from the markets in its own currency at relatively low rates. But countries in the euro zone are facing more painful options. In a world where cost is the priority, either coverage or choice has to be restricted.

One option is to ration cash itself. As Argentina battled to avoid default in 2001, citizens were restricted in the amount of cash they could withdraw from their bank accounts. The *corralito*, as this measure was known, stayed in place even after

default. Iceland introduced capital controls in the wake of its financial crisis, imposing a limit on foreign-exchange transactions of 350,000 kronur (about $3,000) for residents planning to travel abroad. A chaotic Greek default would require capital controls to prevent the assets of the banking system disappearing overnight.

An alternative to rationing cash is to ration goods. Decades of prosperity have accustomed consumers to a wide range of choice. Baskin-Robbins once advertised 31 ice-cream flavours, one for every day of the month; now it offers 1,000. Restaurant menus are no longer a set list of choices but the starting point for negotiations between diner and waiter.

It is hard to imagine this abundance disappearing. But it can. Countries can create their own currencies but this alone does not help buy goods from abroad. If they cannot balance their trade or borrow money at a reasonable rate, they will be unable to afford all the goods their citizens want. (America, with its reserve currency, is privileged in this respect.)

Britain found itself short of dollars after the end of the second world war, once President Harry Truman cancelled the lend-lease programme that provided the country with credit. British politicians decided that the only way to guarantee a minimum standard of living for all citizens was to restrict consumer choice.

The wartime rationing regime was tightened so that the country could pursue an export drive. Consumption of meat, sugar and even clothes was restricted, and the rules were not relaxed until the 1950s. This columnist's father recalled the options as "jam or butter on your bread, but not both".

The critical resource in a modern economy is not food, but power. When power is restricted for whatever reason, governments have to decide which users have priority: factories, hospitals, shops or consumers. China has power rationing now, as does Venezuela (a sign of incredible incompetence in an energy-rich country). Developed economies have not experienced this sort of thing on a regular basis since the 1970s. But that could be the outcome if they are forced into default.

Economist.com/blogs/buttonwood

The euro's surprising resilience

In sickness and wealth

Why the currency markets have not yet lost faith in the euro

AS GREEK protests continued this week, European leaders ratcheted up the rhetoric. Olli Rehn, who is in charge of economic and monetary affairs at the European Commission, said the crisis was the worst in Europe since the second world war. Amid upheavals in Athens and alarm in Brussels, foreign-exchange traders showed surprising *sangfroid*. The euro closed on June 22nd at $1.44, virtually unchanged from the beginning of the month and 8% higher than in early January (see chart). Its value against a basket of currencies is also up so far this year.

The euro's resilience in this latest phase of the sovereign-debt crisis contrasts with what happened last year. The single currency fell sharply when Greece first required a bail-out in May 2010. After staging a recovery it suffered a relapse when Ireland required an emergency rescue. It has been bruised in the latest bout of debt woes, but less so than last year.

A strong countervailing force is buoying the euro. A new *Wirtschaftswunder* in Germany is spreading out to the northern half of the single-currency zone. Despite the distress in southern Europe the euro area grew by 0.8% (an annualised rate of 3.4%) in the first quarter of 2011, faster than America or Britain, while the German economy vorsprunged ahead by 1.5%. On June 17th the IMF raised its growth forecast for the euro area this year while lowering it for America, Britain and Japan.

Against this background the European Central Bank (ECB) has been quick off the mark in pushing up interest rates. Its governing council raised the main policy rate from 1% (where it had stood since May 2009) to 1.25% in April. The markets are expecting a further quarter-point rise on July 7th. The ECB argues that tighter monetary policy is needed to ensure that a largely commodities-driven rise in inflation is contained and does not set off a wage-price spiral. Some wonder whether its zeal is an attempt to regain credibility after making so many compromises in supporting debt-stricken economies.

Whereas the ECB has taken the lead among the big central banks in advanced economies in tightening policy, offering a yield advantage to investors in euro-denominated assets, the US Federal Reserve is only just completing its second round of quantitative easing. That is not the only reason for foreign-exchange traders to be nervous about the dollar. America lacks a credible fiscal strategy to deal with its swollen budget deficit and no one knows if negotiations between its fractious politicians will yield one.

The single currency also appears to have found a new ally. Research by Standard Chartered suggests that China has made a big effort to diversify new reserves away from the dollar this year, with purchases instead favouring the euro. John Higgins of Capital Economics, a consultancy, doubts this has had much of an effect, however. He thinks that currency markets are no longer so nervous about a break-up of the euro on the ground that this might be limited to the departure of weak economies like Greece. But even if a purged euro could conceivably emerge stronger in the long run, the trauma of such an event would surely take its toll on the currency in the short term, he says. The euro will be vulnerable as long as European leaders fail to get on top of the debt crisis.

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Celebrity hedge-fund managers

Kapow!

It's not an easy time to be a star

Masters of the universe no more

THE superheroes of finance seem to have lost some of their powers. Several of the hedge-fund industry's most exalted names are beset by problems more associated with mere mortals. Take John Paulson of Paulson & Co, a $37 billion hedge fund. He became famous after he bet against the housing bubble but is now in the limelight for less flattering reasons. Mr Paulson was the largest shareholder in Sino-Forest, a Chinese forest-plantation operator accused of fraud by short-sellers earlier this month. Its share price plummeted and Mr Paulson sold his stake, dealing his fund a reputational blow and around $500m in losses. His flagship fund is down 20% so far this year.

Hedgies' woes are not just financial. Ikos, a big European quantitative hedge fund, has been shaken by domestic melodrama. Its two founders, Elena Ambrosiadou and Martin Coward, are going through an acrimonious divorce. Recently a colleague of Mr Coward accused Ms Ambrosiadou, who continues to run the firm, of spying on him and even using an undercover agent. Ikos fired back that investigations were needed to protect the firm's proprietary technology, which it accuses Mr Coward and his "acolytes" of trying to "misappropriate".

Divorce courts are not the only ones to worry the industry at the moment. Philip Falcone, a billionaire hedge-fund manager who runs Harbinger Capital Partners, borrowed $113m from his fund to pay his 2008 taxes (the money was repaid in 2010). That caught the attention of the Securities and Exchange Commission (SEC) and the Department of Justice, which are investigating the loan. Investors apparently do not see this as a harbinger of good things to come and are trying to withdraw around $900m from Mr Falcone's $6 billion firm.

Steve Cohen, who runs SAC Capital, a large fund, has found himself in the crossfire between the SEC and Chuck Grassley, a member of the Senate's Judiciary Committee, who has been pushing the SEC for information about how it

handled investigations into 65 suspicious trades at SAC that were identified and referred by the Financial Industry Regulatory Authority. Mr Cohen has not been charged with any wrongdoing, but the torrent of press coverage cannot be helpful.

Insider-trading charges have affected many acclaimed managers. Raj Rajaratnam, the former billionaire manager of Galleon, was convicted of insider trading and conspiracy in May and is awaiting sentencing before trudging off to jail. FrontPoint, a hedge fund once owned by Morgan Stanley, saw Joseph "Chip" Skowron, one of its portfolio managers, charged with insider trading in April; it recently decided to wind down some funds. Steve Eisman, FrontPoint's star manager, has left.

What can be learned from the plight of all these stars? One lesson is that being famous can have its disadvantages, particularly in the hedge-fund world. As Mr Paulson can attest, it's harder to be nimble and to maintain high standards of performance with tens of billions of dollars under management. Funds also risk attracting greater attention from regulators when they become more high-profile. Officials are clearly on the hunt for big fish.

It may be that the hedge-fund industry's top brass are having no more trouble than usual; it's just that investors and the public are being told more than they used to be. It's the "Catch-22 in this business", says Jane Buchan, the boss of Pacific Alternative Asset Management Company, a large fund of funds. Investors have started to demand greater transparency from funds if they're going to hand over their money. But "the more transparent you are, the more vulnerable you become to bad press and rumour-mongering."

The travails of big hedge funds won't necessarily be harmful to the industry, according to Sebastian Mallaby, author of "More Money Than God" (and a former journalist at *The Economist*). "The big guys always get knocked off their pedestals. That makes way for new people to rise up," he says. In the wake of the crisis, however, skittish investors are less likely to take their money to smaller, scrappy shops that do not have name recognition. Losing their powers is one thing. Losing out to the small fry is not yet a big worry.

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American retail banking

The road to agnosticism

As internet and mobile banking take off, the branch is evolving

IS THE future of banking in the branch or in the ether? Two big acquisitions in America point in opposite directions yet both deals make sense. That's because the industry's future lies in multiple distribution channels, not just one.

Capital One, a card issuer that has pushed aggressively into banking, is paying $9 billion for ING Direct, America's largest stand-alone internet bank. Pittsburgh-based PNC has forked out $3.5 billion for Royal Bank of Canada's network of branches in six southeastern states. The first deal was forced: ING Direct had to be divested under the terms of its Dutch parent's bail-out. The second was another case of a foreign bank throwing in the towel after failing to crack America's retail market. In a further example, HSBC's credit-card business is for sale.

After several false dawns, online banking has grown steadily if modestly over the past five years. Internet banks now hold 7% of total deposits in so-called money-market accounts, the segment in which they compete hardest (in contrast to basic current accounts and certificates of deposit). Almost half of all American households now do some banking online. Some 10-15% do their banking on mobile devices, a number that is growing rapidly.

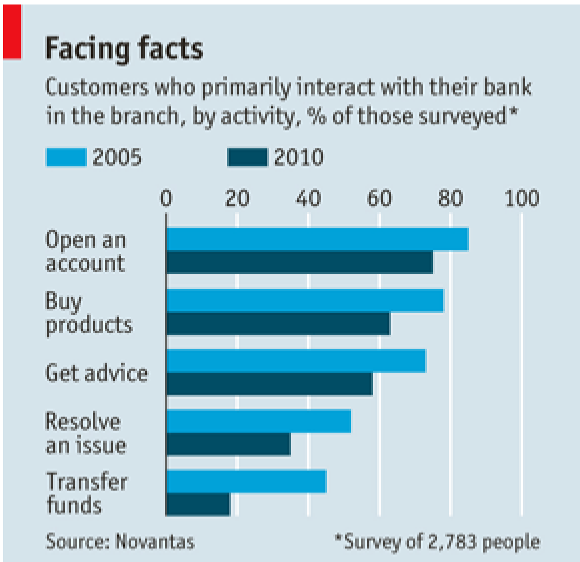
When interest rates are low, as they are today, the appeal for banks of online deposits grows relative to those harvested in the branch, points out Aaron Fine of Oliver Wyman, a consultancy. The reason is that traditional banks hold a lot more

non-interest-bearing and low-interest deposits than direct banks typically do, and the profitmaking opportunities from reinvesting these in wholesale markets shrinks dramatically as rates fall. Indeed, most retail banks will suffer more from this lost "carry" than from more-publicised regulatory curbs on overdraft and card fees. ING Direct's all-in costs per dollar of deposits are now slightly below those of the typical large bank-though they would jump back above if interest rates rose substantially. Online banking is "an implicit bet that rates won't rise too far," says one banker.

It helps internet banks that savers are growing more comfortable with the technology. This has helped drive down to almost nothing the premium these banks must pay for deposits over the rates offered by offline rivals, says Sherief Meleis of Novantas, another consultancy.

Even so, the stand-alone online model has weaknesses. ING Direct has struggled to match its deposit-gathering prowess in lending, and has more money than the typical bank parked in low-yielding securities. Capital One likes to think it can do better with these assets.

Furthermore, rumours of the death of the branch are exaggerated. True, paring the network is an obvious way to shore up profits at a time when it is hard to grow lending (witness the 16-year low in US banks' loan-to-deposit ratios). Bank of America, for instance, is shutting 10% of its branches and slapping extra fees on those who use them instead of digital channels. But JPMorgan Chase plans to open 2,000 new outlets, even after absorbing Washington Mutual, and PNC is one of several large regional banks looking to pick up branches in states where they have no presence. "For an industry whose behaviour can be herd-like, there's a surprising divergence of strategies right now," says Mr Meleis.



Moreover, the branch's role is evolving. Fewer customers use it for routine services, such as withdrawing or transferring funds, but many still value it for more complicated transactions (see chart). Even as BofA trims its network, it is hiring more branch specialists in mortgages, investments and small-business banking. It announced this week that it will double the number of financial advisers in its branches by the end of 2011. Many Americans who bank predominantly online or on their iPhone still consider the density of nearby branches an important factor when choosing their provider, according to surveys.

One option for the cost-conscious bank is to replace traditional branches with cheaper mini-branches, staffed by two or three employees trained to give advice and loans as well as man the counters. Huntington Bancshares is opening 100 such outlets in Giant Eagle grocery stores across Ohio. These cost 85-90% less than normal branches to build and 50% less to run, says Stephen Steinour, the bank's boss. But Huntington is investing heavily in internet and mobile banking, too-and thus "moving towards channel agnosticism".

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Accounting

The balladeer of the balance-sheet

The head of IASB retires with the dream of convergence not yet realised

Sir David, accounting Goliath

ACCOUNTING has very few rock stars but Sir David Tweedie is one of them. True, the Scot may not trash hotel rooms but as the first head of the International Accounting Standards Board (IASB), which sets accounting standards for most of the world's major economies outside America, he is the profession's towering figure. After ten years in the chair, he will hand over to Hans Hoogervorst, a Dutch financial regulator, on July 1st.

Sir David's biggest project has been convergence of IASB's rules with those of America's Financial Accounting Standards Board (FASB). The two had set a June deadline, timed to coincide with Sir David's retirement, to iron out their differences. That won't be met. In April they announced a postponement on four issues: revenue recognition, lease accounting, insurance contracts and which financial instruments to record at "fair", or market, value.

How to treat financial instruments is by far the toughest question. In 2009, under its previous chairman, Bob Herz, FASB narrowly voted 3-2 that all assets should be booked at fair value on banks' balance-sheets. IASB proposed a less zealous, split model whereby loans held mainly for their income rather than for trading purposes could be booked at amortised cost.

Mr Herz left last year, to be replaced by Leslie Seidman. FASB's expanded, seven-member board has now "tentatively" decided to move in IASB's direction. Under a yet-to-be-released proposal, assets to be traded or held for sale would be booked at fair value in profit-and-loss statements. Traditional loans to customers would be booked at amortised cost. In between would be a new category. Debt instruments such as ordinary government bonds would have changes in value booked to "other comprehensive income" (ie, reserves) and not on the income statement until they are sold. So a bank holding Greek debt would immediately take a hit to its reserves if the market price went down. The IASB rule would show the loss only when the bonds were sold, provided they were held for their cash flows.

Mr Hoogevorst planted his flag in February, saying "stability should be a consequence of greater transparency rather than a primary goal of accounting standard-setters". This will please the fair-value partisans. When FASB issues its proposals, IASB may put them to its own members.

Sir David should not be too disappointed that convergence is not complete. That the process has come as far as it has-and that America's Securities and Exchange Commission might decide later this year to adopt IASB's standards-is something no one could have predicted ten years ago, says Nigel Sleigh-Johnson of the Institute of Chartered Accountants of England and Wales. The June deadline was useful for concentrating minds but now, he says, it is more important to get things right.

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Measuring inflation

Price in a trice

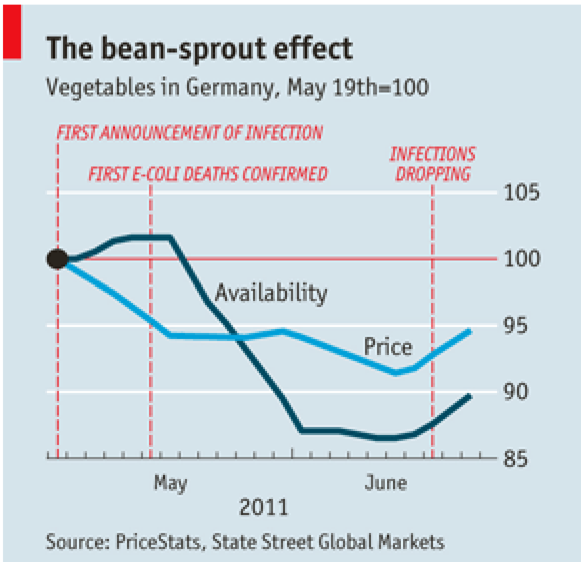
Online retailers offer an immediate measure of inflation

IF THE inflationistas are right, where should they look for signs of accelerating price growth? Many are suspicious of official numbers: John Williams, the boss of an inflation-statistics website called ShadowStats.com, claims American inflation has been underestimated for decades because the Bureau of Labour Statistics (BLS) regularly changes its basket of goods on the ground that consumers shy away from expensive items. And official data are slow to come out.

Help is at hand from the internet. The Billion Prices Project (BPP) estimates daily inflation in 70 countries. Rather than physically checking prices in supermarkets, it uses software to monitor 5m products sold by several hundred online retailers. It reflects a trend for using the web to predict economic indicators before official figures are released. The Bank of England is now using data from Google searches to gauge economic sentiment (terms such as "estate agent" are good indicators of housing transactions, for example). The search giant is working on its own price index based on online shopping.

The BPP is the brainchild of Alberto Cavallo and Roberto Rigobon, two economists at the MIT Sloan School of Management. Mr Cavallo has form. He set up a website in 2008 to track supermarket prices in Buenos Aires and found that inflation in Argentina was three times official estimates. Nothing like that has shown up in America: the BPP's daily inflation rate only marginally overshoots the official measure.

But the project has proved its worth in other ways. The BPP index declined significantly on the day that Lehman Brothers collapsed in September 2008 as online retailers in America immediately cut prices. Official figures did not show a decline in inflation until weeks later.



The BPP only publishes an American price index, but the rest of the data are sold to investors through a partnership with State Street, a financial firm. That dataset has information on product availability as well. When *E. coli* infections spread in Germany at the end of May, the number of vegetables tracked fell as retailers withdrew products. Prices of those vegetables still on online shelves fell rapidly (see chart).

The BPP estimates are not perfect. The data directly capture changes in the prices of retail goods only. Since most services are not widely marketed online, the BPP has to use proxy measures: it calculates health-care costs by weighting changes in the price of wages, energy and drugs. Its reliance on online retailers makes it less suited to less web-savvy emerging markets. And since the BPP weights its index based on the BLS basket, it may still be importing official bias.

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Economics focus

Degrees of democracy

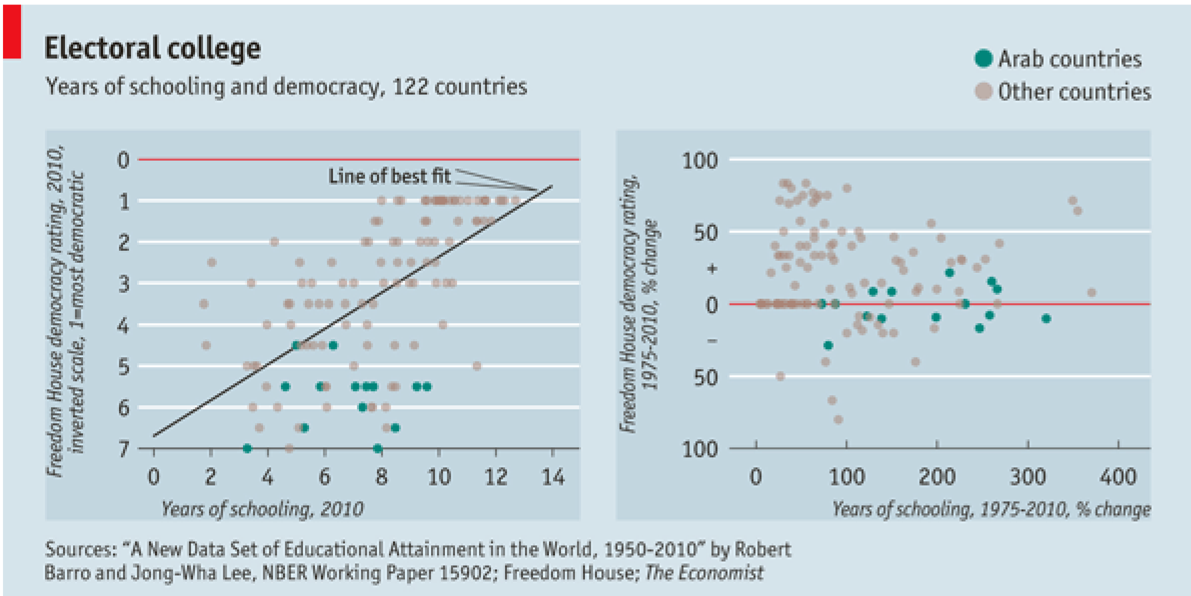
More education does not necessarily lead to greater enthusiasm for representative politics

ON JUNE 20th Zine el-Abedine Ben-Ali, Tunisia's former ruler, was sentenced in absentia to 35 years in prison. Many trace the origins of the popular rebellion that forced him from office to frustration over the treatment by the police of a young man with few job prospects. That combustible mixture of authoritarianism, unemployment and youth has played a big role in sparking many of the popular uprisings across the Middle East and north Africa that followed Tunisia's. But some argue that increased education should also take credit for the Arab spring.

Many of the countries where disaffection with strongmen rulers has spilled over into revolt have seen their education levels rise sharply in recent decades. Young people in these countries are far better educated than their parents were. In 1990 the average Egyptian had 4.4 years of schooling; by 2010 the figure had risen to 7.1 years. Could it be that education, by making people less willing to put up with restrictions on freedom and more willing to question authority, promotes democratisation?

Ideas about the links between education, income and democracy are at the heart of what social scientists in the middle of the last century termed the "modernisation hypothesis". One of its most famous proponents, Seymour Lipset, wrote in 1959 that "education presumably broadens men's outlooks, enables them to understand the need for norms of tolerance, restrains them from adhering to extremist and monistic doctrines, and increases their capacity to make rational electoral choices."

Since then plenty of economists and political scientists have looked for statistical evidence of a causal link between education and democratisation. Many have pointed to the strong correlation that exists between levels of education and measures like the pluralism of party politics and the existence of civil liberties (see left-hand chart). The patterns are similar when you look at income and democracy. There are outliers, of course-until recently, many Arab countries managed to combine energy-based wealth and decent education with undemocratic political systems. But some deduce from the overall picture that as China and other authoritarian states get more educated and richer, their people will agitate for greater political freedom, culminating in a shift to a more democratic form of government.



This apparently reasonable intuition is shakier than it seems. Critics of the hypothesis point out that correlation is hardly causation. The general trend over the past half-century may have been towards rising living standards, a wider spread of basic education and more democracy, but it is entirely possible that this is being driven by another variable. Even if the correlation were not spurious, it would be difficult to know which way causation ran. Does more education lead to greater democracy? Or are more democratic countries better at educating their citizens?

The modernisation hypothesis suggested a particular direction of change: more education and income should beget greater democracy. But as the right-hand chart shows, there is virtually no statistical association at all between changes in a country's level of education and its measured level of democracy. If this is true, there is no particular reason to hope that more education will lead to a more democratic world.

A recent NBER paper* sheds light on why this might be the case. Those who posit that more schooling leads to greater democracy often have specific ideas about how people's attitudes change as a result of their becoming more educated, arguing that it creates people who are more willing to challenge authority. It is possible, however, that education reinforces authority and the power of ruling elites; indeed, it may often be designed to do precisely this. The study tried to find out which of these competing ideas of the effects of education is more accurate.

The authors compared a group of Kenyan girls in 69 primary schools whose students were randomly selected to receive a scholarship with similar students in schools which received no such financial aid. Previous studies had shown that the scholarship programme led to higher test scores and increased the likelihood that girls enrolled in secondary school. Overall, it significantly increased the amount of education obtained. For the new study the authors tried to see how the extra schooling had affected the political and social attitudes of the women in question.

Class divide

What they found was in many ways contradictory. For instance, girls who benefited from the scholarship and got more schooling were more independent and less accepting of the traditional sources of authority within the family. But although education seemed in some sense to have "liberated" them in terms of their personal aspirations, it did not seem to have had the broader effects that proponents of the modernisation hypothesis would have expected. In particular, those with more education did not become more favourably inclined towards democracy. In fact, education deepened their sense of identification with their ethnic group and increased their tolerance for political violence. There was little evidence that having more education made them more engaged in civic life or political organisations.

This is not entirely surprising. Education may make people more interested in improving their own lives but they may not necessarily see democracy as the way to do it. Even in established democracies, more education does not always mean either more active political participation or greater faith in democracy. In India, for example, poorer and less educated people vote in larger numbers than their more educated compatriots. Indeed, the latter often express disdain for, and

impatience with, the messiness of democracy. Many yearn instead for the kind of government that would execute the corrupt and build highways, railway lines and bridges at the dizzying pace of authoritarian China.

* "Education as Liberation?" by Willa Friedman, Michael Kremer, Edward Miguel and Rebecca Thornton. NBER Working Paper 16939, April 2011.

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Correction: Greek banks

Our article on Greek banks (June 18th) said that Standard & Poor's now rated Greece at the lowest notch above default; in fact it is four notches above. We also said that rescheduling would lead to impairments on sovereign debt held by banks: that is not necessarily the case if the principal or interest rate on debt in the banking book stays the same. Sorry.

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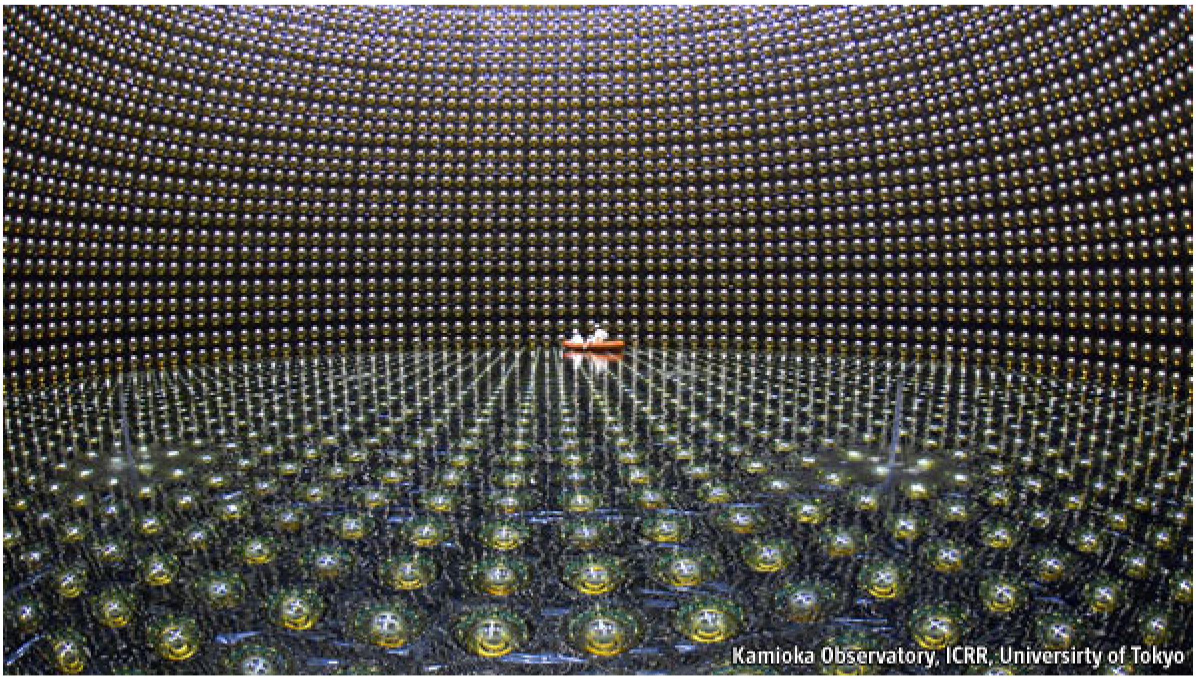
Neutrinos

Delta force

A study of neutrinos may explain why things are made of matter, not antimatter



EVEN by the elevated standards of particle physics neutrinos are weird beasts. They travel within a whisker of the speed of light, have no electric charge, practically no mass and precious little will to interact with anything else. Billions penetrate every square centimetre of the Earth's surface every second without so much as a quiver. This makes them rather hard to detect. So hard that Wolfgang Pauli, the Austrian physicist who postulated their existence in 1930, wagered a case of champagne that no one would ever do so. He lost the bet in 1956. Since then, neutrinos (of which there are now known

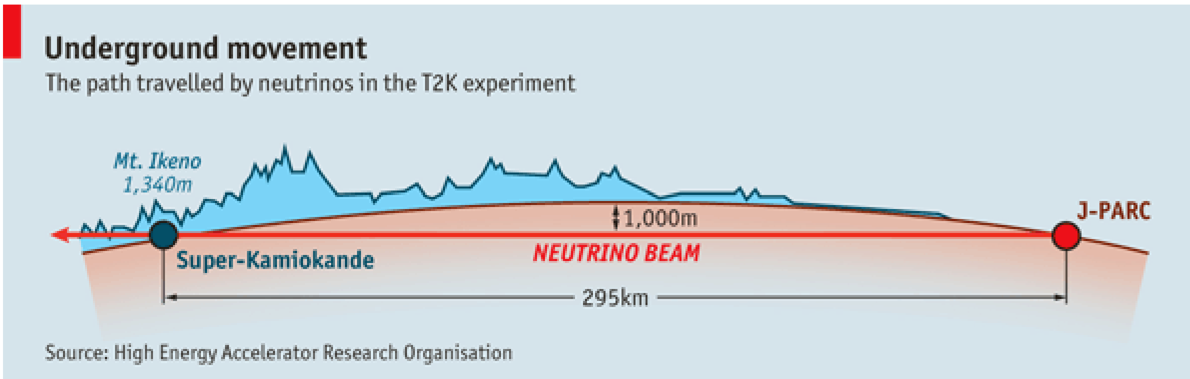
to be three fundamentally different sorts) have allowed researchers to glimpse inside the sun, study exploding stars and examine the universe's distant past.

The latest example of neutrinos' weirdness comes from Japan. Researchers using a detector called Super-Kamiokande think they have observed the beasts changing their fundamental nature in a way not seen before. They are not yet quite sure. Their result has a 0.7% chance of being a fluke. But if it is confirmed, it will have implications for one of the deepest mysteries of the universe-why it is made of matter.

Some leopard. Some spots

The core of Super-Kamiokande is a tank in an old zinc mine. This tank (see above) holds 50,000 tonnes of water. When a neutrino interacts with a water molecule another particle is generated. So-called electron-neutrinos generate electrons. Muon-neutrinos generate heavier, unstable particles called muons. (The third sort, tau-neutrinos, are not involved in the experiment.) These generated particles then create patterns of light that the detectors can distinguish.

In the case of this particular experiment, known as T2K, the neutrinos come from a second laboratory, J-PARC, which is 295km (183 miles) away. They are created in a particle accelerator and beamed through the mountains to the tank (see diagram). The neutrino-manufacturing process at J-PARC smashes protons into rods of graphite to churn out muon-neutrinos. The point is to see if they are still muon-neutrinos when they arrive at Super-Kamiokande. If theory is correct, some will have changed their spots and become electron-neutrinos during the intervening journey.



On June 15th it emerged that T2K had seen six electron-neutrinos. If no spot-changing oscillation were happening it should have seen only one or two. Six is not enough to be sure that oscillation is going on, but it is a strong hint that it might be.

The reason this matters is a number called delta. This is one of the parameters of the formula which physicists think describes oscillation. And, crucially, it also governs the description of the putative asymmetry between matter and antimatter that left matter as the dominant feature of the universe after the Big Bang. At the moment, T2K is not trying to measure delta directly. If the new result is confirmed, however, it should be able to do so. That would be a big deal for physicists.

The T2K experiment has been suspended until December, as J-PARC was damaged in the earthquake in March. Even if it does not come up with the goods soon, though, a host of other experiments might. A detector called NOvA, in Minnesota, will soon be fed neutrinos by Fermilab, America's main particle-physics facility, located near Chicago. Neutrino detectors in France, Hong Kong and South Korea, which receive their quarry from nuclear reactors, are also operational, or soon will be. And in a cavern in Gran Sasso in Italy, the highest part of the Apennines, an experiment is looking at another oscillation, that between muon- and tau-neutrinos.

The search for delta, then, will soon be on in earnest-and with it, the search for the reason why the universe is made of matter. The matter/antimatter question has been bugging physicists for decades. Now, perhaps, it will be answered.

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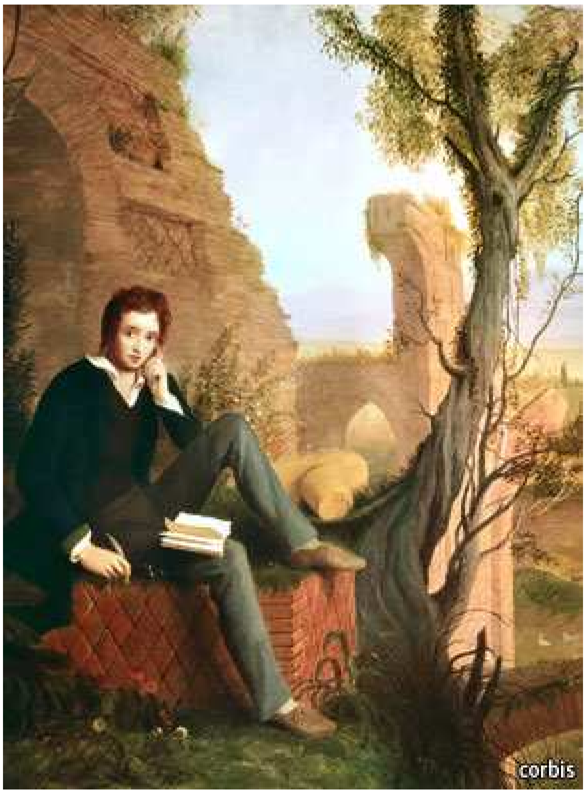
A New York state of mind

Urban brains behave differently from rural ones



Shelley contemplates urban decay

"HELL is a city much like London," opined Percy Bysshe Shelley in 1819. Modern academics agree. Last year Dutch researchers showed that city dwellers have a 21% higher risk of developing anxiety disorders than do their calmer rural countrymen, and a 39% higher risk of developing mood disorders. But exactly how the inner workings of the urban and rural minds cause this difference has remained obscure-until now. A study just published in *Nature* by Andreas Meyer-Lindenberg of the University of Heidelberg and his colleagues has used a scanning technique called functional magnetic-resonance imaging (fMRI) to examine the brains of city dwellers and country bumpkins when they are under stress.

In Dr Meyer-Lindenberg's first experiment, participants lying with their heads in a scanner took maths tests that they were doomed to fail (the researchers had designed success rates to be just 25-40%). To make the experience still more humiliating, the team provided negative feedback through headphones, all the while checking participants for indications of stress, such as high blood pressure.

The urbanites' general mental health did not differ from that of their provincial counterparts. However, their brains dealt with the stress imposed by the experimenters in different ways. These differences were noticeable in two regions: the amygdalas and the perigenual anterior cingulate cortex (pACC). The amygdalas are a pair of structures, one in each cerebral hemisphere, that are found deep inside the brain and are responsible for assessing threats and generating the emotion of fear. The pACC is part of the cerebral cortex (again, found in both hemispheres) that regulates the amygdalas.

People living in the countryside had the lowest levels of activity in their amygdalas. Those living in towns had higher levels. City dwellers had the highest. Not that surprising, to those of a Shelleyesque disposition. In the case of the pACC, however, what mattered was not where someone was living now, but where he or she was brought up. The more urban a person's childhood, the more active his pACC, regardless of where he was dwelling at the time of the experiment.

The amygdalas thus seem to respond to the here-and-now whereas the pACC is programmed early on, and does not react in the same, flexible way as the amygdalas. Second-to-second changes in its activity might, though, be expected to be correlated with changes in the amygdalas, because of its role in regulating them. fMRI allows such correlations to be measured.

In the cases of those brought up in the countryside, regardless of where they now live, the correlations were as expected. For those brought up in cities, however, these correlations broke down. The regulatory mechanism of the native urbanite, in other words, seems to be out of kilter. Further evidence, then, for Shelley's point of view. Moreover, it is also known that the pACC-amygdala link is often out of kilter in schizophrenia, and that schizophrenia is more common among city dwellers than country folk. Dr Meyer-Lindenberg is careful not to claim that his results show the cause of this connection. But they might.

Dr Meyer-Lindenberg and his team conducted several subsequent experiments to check their findings. They asked participants to complete more maths tests-and also tests in which they mentally rotated an object-while investigators chided them about their performance. The results matched those of the first test. They also studied another group of volunteers, who were given stress-free tasks to complete. These experiments showed no activity in either the amygdalas or the pACC, suggesting that the earlier results were indeed the result of social stress rather than mental exertion.

As is usually the case in studies of this sort, the sample size was small (and therefore not as robust as might be desirable) and the result showed an association, rather than a definite, causal relationship. That association is, nevertheless, interesting. Living in cities brings many benefits, but Dr Meyer-Lindenberg's work suggests that Shelley and his fellow Romantics had at least half a point.

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Solar power from space

Beam it down, Scotty

Harvesting solar power in space, for use on Earth, comes a step closer to reality

THE idea of collecting solar energy in space and beaming it to Earth has been around for at least 70 years. In "Reason", a short story by Isaac Asimov that was published in 1941, a space station transmits energy collected from the sun to various planets using microwave beams.

The advantage of intercepting sunlight in space, instead of letting it find its own way through the atmosphere, is that so much gets absorbed by the air. By converting it to the right frequency first (one of the so-called windows in the atmosphere, in which little energy is absorbed) a space-based collector could, enthusiasts claim, yield on average five times as much power as one located on the ground.

The disadvantage is cost. Launching and maintaining suitable satellites would be ludicrously expensive. But perhaps not, if the satellites were small and the customers specialised. Military expeditions, rescuers in disaster zones, remote desalination plants and scientific-research bases might be willing to pay for such power from the sky. And a research group based at the University of Surrey, in England, hopes that in a few years it will be possible to offer it to them.

Heavenly power

This summer, Stephen Sweeney and his colleagues will test a laser that would do the job which Asimov assigned to microwaves. Certainly, microwaves would work: a test carried out in 2008 transmitted useful amounts of microwave energy between two Hawaiian islands 148km (92 miles) apart, so penetrating the 100km of the atmosphere would be a doddle. But microwaves spread out as they propagate. A collector on Earth that was picking up power from a

geostationary satellite orbiting at an altitude of 35,800km would need to be spread over hundreds of square metres. Using a laser means the collector need be only tens of square metres in area.

Dr Sweeney's team, working in collaboration with Astrium, a satellite-and-space company that is part of EADS, a European aerospace group, will test the system in a large aircraft hangar in Germany. The beam itself will be produced by a device called a fibre laser. This generates the coherent light of a laser beam in the core of a long, thin optical fibre. That means the beam produced is of higher quality than other lasers, is extremely straight (even by the exacting standards of a normal laser beam) and can thus be focused onto a small area. Another bonus is that such lasers are becoming more efficient and ever more powerful.

In the case of Dr Sweeney's fibre laser, the beam will have a wavelength of 1.5 microns, making it part of the infra-red spectrum. This wavelength corresponds to one of the best windows in the atmosphere. The beam will be aimed at a collector on the other side of the hangar, rather than several kilometres away. The idea is to test the effects on the atmospheric window of various pollutants, and also of water vapour, by releasing them into the building.

Assuming all goes well, the next step will be to test the system in space. That could happen about five years from now, perhaps using a laser on the International Space Station to transmit solar power collected by its panels to Earth. Such an experimental system would deliver but a kilowatt of power, as a test. In 10-15 years Astrium hopes it will be possible to deploy a complete, small-scale orbiting power station producing significantly more than that from its own solar cells.

Other researchers, in America and Japan, are also looking at using lasers rather than microwaves to transmit power through the atmosphere. NASA, America's space agency, has started using them to beam energy to remotely controlled drones. Each stage of converting and transmitting power results in a loss of efficiency, but with technological improvements these losses are being reduced. Some of the latest solar cells, for instance, can covert sunlight into electricity with an efficiency of more than 40%. In the 1980s, 20% was thought good.

Whether the Astrium system will remain a specialised novelty or will be the forerunner of something more like the cosmic power stations of Asimov's imagination is anybody's guess. But if it comes to pass at all, it will be an intriguing example, like the geostationary communications satellites dreamed up by Asimov's contemporary, Arthur C. Clarke, of the musings of a science-fiction author becoming science fact.

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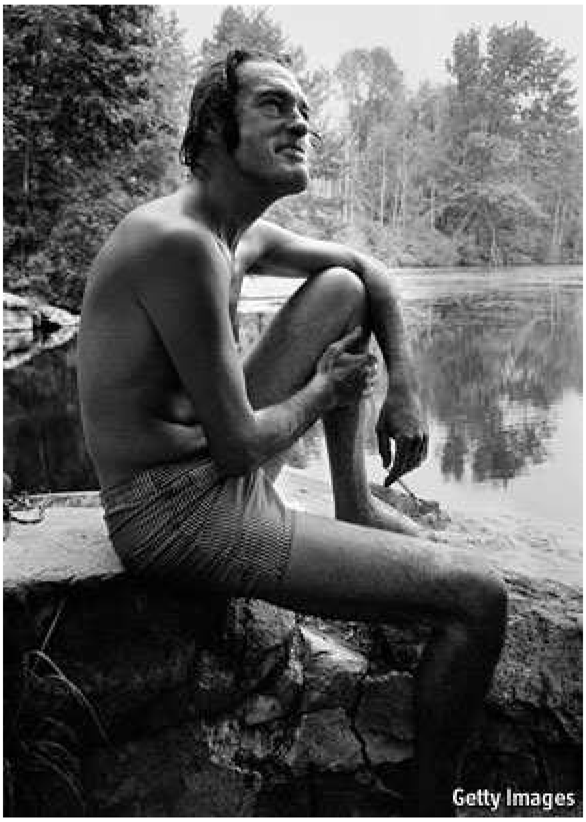
LSD

Acid tests

Research into hallucinogenic drugs begins to shake off decades of taboo



Leary contemplates his navel

THE psychedelic era of the 1960s is remembered for its music, its art and, of course, its drugs. Its science is somewhat further down the list. But before the rise of the counterculture, researchers had been studying LSD as a treatment for everything from alcoholism to obsessive-compulsive disorder (OCD), with promising results.

Timothy Leary, a psychologist at Harvard University, was one of the best-known workers in the field, but it was also he who was widely blamed for discrediting it, by his unconventional research methods and his lax handling of drugs. Now, the details of Leary's research will be made public, with the recent purchase of his papers by the New York Public Library. These papers will be interesting not only culturally, but also scientifically, as they reflect what happened between the early medical promise of hallucinogens and their subsequent blacklisting by authorities around the world.

American researchers began experimenting with LSD in 1949, at first using it to simulate mental illness. Once its psychedelic effects were realised, they then tried it in psychotherapy and as a treatment for alcoholism, for which it became known at the time as a miracle cure.

By 1965 over 1,000 papers had been published describing positive results for LSD therapy. It, and its close chemical relative psilocybin, isolated from hallucinogenic mushrooms, were reported as having potential for treating anxiety disorders, OCD, depression, bereavement and even sexual dysfunction. Unfortunately, most of the studies that came to these conclusions were flawed: many results were anecdotal, and control groups were not established to take account of the placebo effect.

Still, the field was ripe for further study. But alongside growing public fear of LSD, Leary's leadership had become a liability. He was seen less and less as a disinterested researcher, and more and more as a propagandist. In 1962, amid wide publicity, the Harvard Psilocybin Project was shut down. Leary took his research to an estate in upstate New York, where he also hosted a stream of drug parties. Eventually both LSD and psilocybin were proscribed.

Which was a pity because, like many other drugs the authorities have taken against as a result of their recreational uses, hallucinogens have medical applications as well. But time heals all wounds and now, cautiously, study of the medical use of hallucinogens is returning.

Psilocybin has shown promise in treating forms of OCD that are resistant to other therapies, in relieving cluster headaches (a common form of chronic headache) and in alleviating the anxiety experienced by terminally ill cancer patients. The first

clinical study of LSD in over 35 years, also on terminally ill patients, is expected to finish this summer. Peter Gasser, the Swiss doctor leading the experiment, says that a combination of LSD and psychotherapy reduced anxiety levels of all 12 participants in the study, though the statistical significance of the data has yet to be analysed.

Research into LSD is not confined to medicine. Franz Vollenweider, of the Heffter Research Institute in Zurich, for example, is scanning people's brains to try to understand how hallucinogenic drugs cause changes in consciousness.

And biotechnology may lead to a new generation of hallucinogenic drugs. Edwin Wintermute and his colleagues at Harvard have engineered yeast cells to carry out two of six steps in the pathway needed to make lysergic acid, the precursor of LSD. They hope to add the other four shortly. Once the pathway has been created, it can be tweaked. That might result in LSD-like drugs that are better than the original.

Even if that does not happen, making lysergic acid in yeast is still a good idea. The chemical is used as the starting point for other drugs, including nicergoline, a treatment for senile dementia. The current process for manufacturing it is a rather messy one involving ergot, a parasite of rye.

It may, of course, be that LSD has no clinical uses. Even when no stigma attaches to the drugs involved, most clinical trials end in failure. But it is worth seeing whether LSD might fulfil its early promise. And if the publication of Leary's archive speeds that process up by exorcising a ghost that still haunts LSD research, then the New York Public Library will have done the world a service.

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The pull of religious relics

Holy jewels

A history of Christianity in 100 reliquaries

THE golden bust of the man with the curly beard and wide-open eyes is the first thing visitors notice when they enter the new exhibition at the British Museum (BM). The golden man doesn't so much welcome arrivals as buttonhole them. This representation of St Baudime was intended to seize attention when it was made in the 12th century-and it still does.

The statue was created to hold a holy relic, in this case a vial of St Baudime's blood. Relics are not mementoes, aids to remembering loved ones. They are religious objects. Christians in the Middle Ages believed that the relics of a saint could be used to intercede with God just as the saint had done in life. "Treasures of Heaven" begins in the fourth century, when the Emperor Constantine legalised Christian worship, and goes on to explore the pilgrimages to churches that were built to house the reliquaries of saints. Pilgrim badges were souvenirs of these journeys and, if brought into contact with the church's reliquary, holy objects themselves. The show ends with the Protestant Reformation in the 15th century by which time Martin Luther, an uncompromising German priest and theologian, asserted that the veneration of saints through their relics had reached a point where it was drawing people away from the divine, not bringing them closer.

The exhibition, which has arrived in Britain from Cleveland and Baltimore, has brought together more than 100 reliquaries, almost all of them magnificent examples of medieval goldsmiths' work. Loans have come from the Vatican, as well as monasteries and museums in Europe and America. They contain fragments reputed to be from the Virgin Mary's bed or tiny bits of saintly skeletons. Holiest of all are relics associated with Jesus Christ. Reliquary crosses were made to conceal slivers of the "true cross" on which Jesus was crucified. Body-part reliquaries-in the shape of an arm, a foot, a head-are the boldest works. It is easy to imagine that when the silver reliquary foot of St Blaise (pictured above), that dates back to the 13th century, was placed on an altar it gripped the congregation's attention.

The gorgeousness of reliquaries dominates the exhibition. Their beauty was homage to the saint and a material manifestation of his or her spiritual magnificence. Medieval reliquaries are usually made of luxurious materials: gold, silver and rock crystal. They are inset with ancient cameos and intaglios, precious and semi-precious stones and enamels. Each element had meaning: gold, which does not tarnish, signifies incorruptibility; heavenly blue sapphires were thought to improve eyesight.

"Treasures of Heaven" makes particularly good use of the BM's grand, circular former Reading Room. Alan Fairlie, who designed the exhibition, has arranged the displays so that the soaring, pale blue dome is almost always visible. Large open vistas cut across the room's 39-metre diameter. The sound of liturgical music reinforces the churchy allusions.

The show opens with "The Classical Past". On view are Roman sarcophagi, often with peaked roofs and looking like marble houses. In creating reliquaries, early Christians followed Roman funerary practices. Many resemble houses. However, these subtly enamelled caskets, containing fragments rather than entire bodies, are much smaller than Roman tombs. Why did early Christians depart from the contemporary Roman and Jewish practice of burying bodies whole? The answer may be that often only fragments were left of those who were tortured and then martyred for refusing to renounce their faith. Their remains would be secretly gathered up by the faithful. Any remnant, however small, was regarded as holy.

"From East to West" follows the trail of relics from Jerusalem to Constantinople and then to Venice. The "Reliquary Arm of St George" nicely illustrates the tale. In Byzantine times a simple silver sheath was made to hold a piece of the saint's arm. In the 14th century when it arrived in Venice, a taller, more elegant reliquary was created for both sheath and bone (though the arm bone was deemed too precious to be put on show in London and has remained at home in St Mark's in Venice).

"Private Devotion and Power" includes one of the show's most impressive jewel-like objects, "The Holy Thorn Reliquary". The crown Christ wore when he was crucified was said to have been carried from Jerusalem to Constantinople. Later it was brought to France where Louis IX paid 135,000 livres for it in 1239, nearly four times what he spent constructing the Sainte-Chapelle, the exquisite reliquary chapel built to house it. The king gave a few single thorns as special gifts. Jean, Duc de Berry, commissioned a gold and enamelled reliquary to house his.

"Treasures of Heaven" is sponsored mainly by John Studzinski, global head of Blackstone Advisory Partners, in a rare example of private philanthropy. Mr Studzinski is a devout Roman Catholic. But one need not perceive reliquaries as intermediaries with the divine to be delighted and moved by this show. These are jewels with soul as well as beauty, a rewarding introduction to the early history of Christianity and the medieval mind.

"Treasures of Heaven: Saints, Relics and Devotion in Medieval Europe" is at the British Museum, London, until October 9th

Translating French poetry

Realms of the ideal

Voices across the ages

The face that dreamed a thousand words

Illuminations. By Arthur Rimbaud, translated by John Ashbery. *W.W. Norton; 176 pages; $24.95. Carcanet; pound12.95.*
Buy from Amazon.com, Amazon.co.uk

ARTHUR RIMBAUD, the *enfant terrible* of French 19th-century poetry and outcast from Parisian literary life, was unaware that his final work, "Illuminations", was ever published. He was thought to be dead. In fact, by the time it came out in 1886, Rimbaud had given up poetry to be a trader in Africa, a "first-rate Arabist". He spoke a variety of local languages and dialects, and moved perpetually from place to place just as, years before, he and his lover, Paul Verlaine, also a poet, had gone back and forth between Paris and London.

Even at his death in 1891, aged 37, he remained seemingly unaware or indifferent to the fact that "Illuminations" had been brought out by Verlaine and others, or that what one publisher deemed a "risky pack of cards" was becoming one of the groundbreaking works of modern French poetry, its influence felt beyond Rimbaud's rock-star image as an iconic scowling teenager.

Comprising 43 prose poems and two of the first examples of French free verse, "Illuminations" is a dazzling collection of fragments, apocalyptic cityscapes and dreamlike vignettes, all brought together under Rimbaud's exclamatory delight in language. Full of faint Anglicisms, Rimbaud took words that made perfect sense in English such as "snowflakes" and translated them into French, as *eclats de neige*-shards or splinters of snow-making the familiar strange in both the language and content of his poetry. In one poem, "Historic Evening", a card game is conducted at the bottom of a pond, one of many of Rimbaud's "parade of enchantments", while "pastures of steel and emerald" appear in another. Rimbaud created a world in which the sky "bends back, recedes and descends" in hallucinogenic mystic landscapes; his work, like his life, was fantastic and disquieting.

Translating such a bold and difficult collection is a hard task. But it is one which John Ashbery, a Pulitzer prize-winner who, as a young man, was considered to be part of the "New York School" of poets with Frank O'Hara and Kenneth Koch, takes on with the clarity and skill of a translator who is a writer in his own right.

Mr Ashbery, born in America in 1927, is not afraid to combine liveliness with lucidity, capturing the panorama of sights and sounds that Rimbaud evokes, and to convey some of the startling, risky aspects of Rimbaud's language. In translating lines such as "A gust of wind opens up opera-like breaches in the walls", Mr Ashbery is faithful to both the meaning and surreal tone of Rimbaud's work. Mr Ashbery's clear prose also manages to avoid the tones of whimsy that Rimbaud could suggest in English. His translation attempts to give weight to both the mystical and cynical aspects of "Illuminations".

Occasionally, Mr Ashbery's English formalises Rimbaud's more rough and ready French. What was *se fut rassise* (had settled or sat down again), for example, is rendered by Mr Ashbery into "regained its composure". Rimbaud's alliteration and delight in internal rhymes is sometimes lost in the English. However, this dual edition also contains the French original, so his words are never too far away.

And one word of Rimbaud's which recurs throughout "Illuminations" is *eclater*. Mr Ashbery does an admirable job of translating this word and its derivatives variously as "dazzle", "glitter", "sparkle" or "glint", capturing some of the brightness of Rimbaud's lines. But the other meaning of *eclater*-to splinter, burst, or blow up-appears rarely. Both meanings are never present at once. In such a way, any translation of Rimbaud can display the sparkle and seductive glitter of his work, but does so at the cost of minimising his explosive force.

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The landscapes of Samuel Palmer

Fields of dreams

Fields of dreams

Trembling in the gloaming

Mysterious Wisdom: The Life and Work of Samuel Palmer. By Rachel Campbell-Johnston. *Bloomsbury; 381 pages; pound25*. Buy from Amazon.co.uk

SIR KENNETH CLARK, a British art historian and the youngest ever director of the National Gallery, once described Samuel Palmer as the English Vincent van Gogh. There were similarities: neither was appreciated in his lifetime, both died feeling sorry for themselves and each was a master of richly sensuous colour. Samuel Palmer did his best work in his 20s in a Kentish village called Shoreham, but the paintings he was most proud of lay unseen in a folder he called "Curiosity Portfolio".

When the paintings and his later etchings were finally put on show together 55 years after his death in 1881, they were a revelation. Clearly the work of a most accomplished painter, they influenced fine British landscape artists such as John Piper and Paul Nash. More recently, Palmer became a victim of influential left-wing art historians who believed his work was tainted by his God-fearing high Toryism. (It is true that Palmer thought the Reform Act of 1832 was a thoroughly bad thing.) However, a comprehensive exhibition at the British Museum in 2005, which transferred to the Metropolitan Museum of Art in New York the following year, revived his reputation as an artist capable of inspiring uncomplicated pleasure in paint.

Palmer had been the leading light in a brotherhood of painters called the "Ancients", because of their preference for an archaic Gothic culture. As a young man, he was a free spirit. He had no academic training and believed that the best pictures have "a curiousness in their beauty-a salt on their tails by which the imagination catches hold on them". Palmer's subjects were golden fields of corn, fruit trees with bursting white blossom, rosy ripe apples, trees with unnaturally large leaves, plump sheep and thin peasants; a church spire often sits in the background. Moons, both crescent and full, provide a thin light in the gloaming. The mark of his originality is that they are instantly recognisable. Forgers have found Palmer irresistible, but they never could do the intricate layers of paint.

Ever since 1550, when Giorgio Vasari published his lives of the Renaissance masters, artists have been a rewarding subject. Palmer is no exception. Although the publishers have been mean with illustrations, his life is deftly told by Rachel Campbell-Johnston, who is a critic on the *Times*. It is the story of a dedicated young artist who was inspired by a fellow visionary, William Blake. When Palmer met Blake, he declared that to walk with him was like walking with the prophet Isaiah. Blake inquired of Palmer whether he worked "with fear and trembling". When Palmer said yes, Blake replied: "You'll do."

Yet he was brutally brought down by John Linnell, a successful Victorian landscape artist, who had been his mentor. Palmer married Linnell's daughter Hannah, and between them, his wife and his father-in-law were determined to perform an artistic lobotomy and eradicate Palmer's unique primitive style. Work accepted by the Royal Academy rarely sold, and Palmer was persuaded to adopt the classically inclined taste of the time. Yet when he produced the conventional landscapes favoured by Linnell, they did not sell either. Palmer was driven to teaching and receiving handouts from the father-in-law who ridiculed and humiliated him in the presence of fellow artists. Palmer said dolefully to his wife: "I believe I have been ill-used and unjustly neglected as an artist, as well as in many other ways." Samuel Palmer's reputation may buckle a bit under the strain of a comparison with van Gogh, but he is neglected no longer.

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Israeli counterterrorism

Tactics over strategy

Confronting force with force

A High Price: The Triumphs and Failures of Israeli Counterterrorism. By Daniel Byman. *Oxford University Press; 496 pages; $34.95 and pound20*. Buy from Amazon.com, Amazon.co.uk

WHAT can the world learn from Israel about counterterrorism? Quite a lot, one might think. In a new book Daniel Byman sets out to extract that learning in this survey of Israel's responses to its foes, from the early Palestinian *fedayeen* raids and the first aircraft hijackings to the rocket attacks of Hamas and Hizbullah, taking in right-wing Jewish terrorism along the way.

Yet the broader lessons for other countries fighting asymmetric conflicts are few. That is partly because Mr Byman draws hardly any comparisons with them-an odd omission, given his stated goal-but also partly because, as he notes, Israel has usually been better at specific tactics than overall strategy. Under constant threat, with fractious coalition governments that cave in easily to public demands for reprisal, and with practically no institutions for long-term planning, Israel tends to be reactive and short-termist. Tactical victories can become strategic defeats. The killing of Hamas's master bomb-maker, Yahya "the Engineer" Ayyash, in 1996, during Shimon Peres's premiership, no doubt dented Hamas's capabilities for a time, but it may also have contributed (Mr Byman seems undecided on this point) to a renewed wave of bus bombings that helped the hawkish Binyamin Netanyahu defeat Mr Peres in that year's election, dealing another blow to the peace process.

More broadly, Israel's blanket measures against the populations in the West Bank and Gaza may catch or kill terrorists, but help breed more of them-as of course does the continued occupation. Israel's campaign in Lebanon in 1982 drove out the Palestine Liberation Organisation but encouraged the rise of Hizbullah. The undermining of Yasser Arafat's Fatah movement in Palestine helped Hamas flourish.

Yet restraint has not always helped Israel either. When it sent its army to hunt militants in Jenin's refugee camp in 2002, it used mostly foot soldiers rather than air strikes and tanks, to limit civilian casualties. Fifty-two Palestinians died, at least half of them militants, as did 23 Israeli soldiers. American military officers told Mr Byman that a similar operation in Iraq would have killed hundreds of civilians. But because the Israeli army bulldozed a quarter of the camp and initial reports overestimated the death toll, Jenin remains etched in Palestinian memory as one of Israel's worst atrocities.

The sense that it will be condemned anyway, and must therefore think of its soldiers' lives first, has contributed to Israel's more aggressive doctrine of recent years: witness the far higher civilian death tolls in its campaigns in Lebanon and Gaza in 2006 and in Gaza in 2008-09. Those campaigns ignited a global debate about the need for "proportionality" when attacking an enemy that hides among civilian populations.

Mr Byman has no firm answer to that debate. Disproportionate violence is abhorrent. But a proportionate response isn't an effective deterrent. But again, the condemnation that even proportionate violence invites also makes the deterrent less effective. The same applies to most of the dilemmas he raises. Judging the Jenin raid, he points out, depends on whether you see it as a military operation (quite restrained) or a police action (very violent). The Israeli army's now-banned use of Palestinian residents as human shields was morally dubious but also saved lives on both sides. In short, there are no easy answers.

This is, then, an admirably even-handed book, especially considering the extensive reliance it places on Israeli sources. It is scathing about short-sightedness, moral weakness and political expediency on all sides. But it seems as if the only broad conclusion is that counterterrorism is complicated, especially when politics is involved, which it virtually always is. A worthy reminder, but hardly a revelation.

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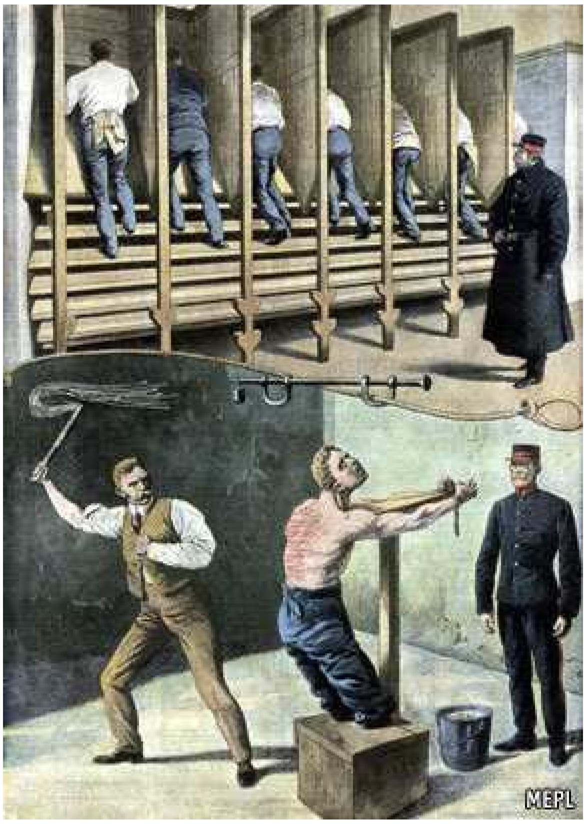
America's penal system

Sing Sing or the lash

Should America flog criminals instead of jailing them?



This won't hurt much

In Defense of Flogging. By Peter Moskos. *Basic Books; 183 pages; $20 and pound11.99*. Buy from Amazon.com, Amazon.co.uk

IMAGINE that you-or, if you prefer, a younger, more reckless version of you-committed a crime. A bar brawl, driving home drunk again, some tax fiddling, getting caught with a more-than-trivial but less-than-kingpin amount of illegal drugs: something, in any event, that got you sentenced to a few years in prison. And say you were offered a choice: you could

either spend those years behind bars, or you could get ten lashes. Certainly painful, probably humiliating, but it would be done under close medical supervision by a licensed flogger, and it would be over in minutes. You would recover, except for the scarring, in a few weeks. And you could get on with your life. You may think flogging is barbaric, but is there any question which you would choose if you could? According to Peter Moskos, a sociologist whose previous book, "Cop in the Hood", detailed his year spent as a Baltimore beat cop: "If flogging were really worse than prison, nobody would choose it."

The modern American prison system evolved as an alternative to flogging: penitentiaries were designed to "cure" prisoners of their criminality-to render them penitent-rehabilitating them into productive members of society. On this score, as on most others, it has failed. Indeed, prisons seem to cause more crime than they prevent, hardly surprising when you throw a bunch of criminals together with nothing to do and lots of time. Today roughly 2.3m people live in America's prisons, more than live in any American city other than New York, Los Angeles or Chicago. America's incarceration rate of 750 per 100,000 is five times the world average; roughly one in every 31 Americans-and one in every 11 African-Americans-is under some form of correctional control, whether prison, probation or parole.

Some prison inmates are incorrigibly violent and must be kept apart from society, but most are not. They are there to be punished, hence the maxim, "We build prisons for people we're afraid of and fill them with people we're mad at." Flogging, Mr Moskos argues, would at least let society punish people swiftly and efficiently. Brutal and archaic it may be, but Mr Moskos convincingly argues that America's prison system is at least as inhumane. "If we really wanted to punish people," Mr Moskos writes, "we could sentence drug offenders to join gangs and fear for their lives; we could punish child abusers to torture followed by death; we could force straight men to have semiconsensual prison-gay sex...All these things already happen, but we just sweep them under the rug and look the other way."

The system is also broken: entities that profit from incarceration-prison-guard unions and private-prison builders-lobby for longer sentences, while politicians build prisons in poor rural areas. "The cynical among us," Mr Moskos writes, "might even say we're spending billions of dollars to pay poor rural unemployed whites to guard poor urban unemployed blacks." And indeed prisons tend to be filled with poor minorities: more than half of all black men without a high-school diploma spend time in jail. Though in recent years a few states have started to roll back against the trend of ever longer, ever harsher sentencing, these efforts amount to little more than bailing out a sinking supertanker with a teacup.

Mr Moskos's proposal begins as a provocation and ends bleakly plausible. But flogging is still flogging. There may exist little political will to legalise drugs or rethink how and why criminals are punished, but America is not about to start whipping people again anytime soon. Perhaps the most damning evidence of the broken American prison system is that it makes a proposal to reinstate flogging appear almost reasonable. Almost.

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Fiction from Lebanon

Wet dreams

A banned Arabic novel

As Though She Were Sleeping. By Elias Khoury, translated by Humphrey Davies. *Maclehose Press; 368 pages; pound18.99*. Buy from Amazon.co.uk

ELIAS KHOURY'S "As Though She Were Sleeping" follows Meelya, a young Lebanese woman, as she dreams her way into marriage with Mansour. It drifts between her home of Beirut and Nazareth, as Meelya remembers her childhood and imagines her future. Newly married she wanders the streets of Nazareth ceaselessly, "becoming a line in a large book that she read and lived at the same time." Meelya's dreams, both by night and by day, are filled with memories of her uncle who hung himself from a bell rope and of salty days swimming with her brother.

Mansour is baffled by his wife's dreamy contemplations. He longs for clarity, for Meelya to understand that "words are supposed to be spoken as a group, meaning they have to be arranged inside your head first; that way they make sense." She delights in the taste of speech, its flavour lingering in her mouth in the morning, like dew dividing night from day. Words frustrate her, like fastened buttons at which she can only fumble. They are meaningless, a way for people "to fill the spaces that separate them from others, to fill their souls with the sound of words".

The book, which was written originally in Arabic, is ripe with eroticism, the main reason it was banned from the 2008 Cairo International Book Fair. Mansour dives into Meelya, her drowsy moans transforming "him into a swimmer in a sea". He makes love to his wife while she slumbers, desperately trying to quench the thirst that love and marriage and her silence awaken in him.

Meanwhile the world is changing. Awaiting the birth of their son, they live through the creation and infancy of Israel. Mr Khoury, who is closely associated with the Palestinian cause, weaves his politics and poetics together. Mansour, a lover of verse, tells Meelya that Palestine must wait for a poet to come to its salvation. In years to come, when this lyric saviour emerges, the Palestinians will discover that their country "can be fashioned only out of poetry". Meelya's response is fierce. She is ready to go into battle, "with the poetry we know how to write", certain of their victory.

Mr Khoury's novel plays with time, flickering back and forth, leaving the reader bewildered at times. Reality slips from view, obscured by a hazy blend of Meelya's dreams and visions. When Mansour tries to correct her memories of their wedding night, she scolds him: "You remember one way and I remember another, and in the end it doesn't matter." The reader will occasionally sympathise with Mansour. "As Though She Were Sleeping" is a challenging read. Mr Khoury's words tumble over the pages in enthralling but sometimes elusive prose. But it is all the more mesmerising for being so.

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Yelena Bonner

Yelena Bonner, fighter for human rights, died on June 18th, aged 88

AS A child, Yelena Bonner loved to be alone. As soon as she could walk she wandered away, preferably into warm spring rain. At the family's summer dacha at Sestroretsk she strayed deep into the forest. When they moved to Moscow, she was out roaming the streets. Adult supervision infuriated her. Alone, she would secretly practise the things she was afraid of doing-climbing trees, going high on swings. She revelled in "a special state of separateness from everyone and everything".

Strange, then, that her later life was given up totally to others. She became a wartime nurse on troop trains, dealing with crowds of refugees as well as soldiers, falling asleep exhausted in waiting rooms with the cries of new babies in her ears. In the post-war Soviet Union she sent food parcels to political prisoners and attended their trials, until her first marriage collapsed in the chaos of caring for them. In the 1970s she called the smoke-filled kitchen of her tiny flat in Moscow "the inn of merry beggars" after the dissident writers and intellectuals who crammed into it, seeking her help. She debated, typed, petitioned, monitored Soviet violations of the Helsinki accords on human rights, recorded those abuses for the *Chronicle of Current Events*, until her heart hurt, or her war-damaged eyes could scarcely see. Human rights were not a vague or general ideal as far as she was concerned. Promoting them meant defending each individual victim.

One man in particular she persuaded of this. In 1970 she fell intensely in love with an eminent physicist, Andrei Sakharov, creator of Russia's hydrogen bomb. He too had dissident leanings; they met while picketing a trial. And he too was compulsively solitary: as well as genius, she recognised "extreme loneliness" in him. From that moment, though she fiercely insisted that she was her own person, theirs was a joint cause. They were a unit, he radiating quiet composure, she nervy, passionate, sucking on cigarettes while she talked; he abstracted, lost in his writing, while she made jam, stewed chicken, washed floors and organised dissent, a "doer" always.

He went on hunger strike for her, at last persuading the authorities to let her go abroad for medical treatment. While there, in 1975, she collected his Nobel peace prize and delivered his speech for him. When he was sentenced to internal exile in Gorky in 1980 she was his connection to the world, ferrying him books and news, sending his writings abroad. Single-handed, she reminded the West that he was working and alive. At one point she was exiled too for anti-Soviet agitation. They were "alone together" in Gorky then, and deeply happy in their aloneness, though "people" still moved their glasses and toothbrushes round in the flat, and slashed the tyres on their ancient car.

Andrei once persuaded her to ask the authorities for pardon. It was tactical, but stuck in her craw. When people attacked her for something, her instinct was to offend them more. At school, when her hair-bow was called "petit bourgeois" by a teacher, she wore a bigger one. Called a money-grubbing Jew for marrying Sakharov (a frequent slur), she longed for a yellow star to blazon on her coat.

The lightning ball

Her mother, whose name she took, was never an active Jew. Her foibles, like her insistence on eating sweets at bedtime, seemed to come from her Armenian father. But neither parent had much time for her. They were too busy building their communist revolution to care about their sickly, "useless", "ugly" daughter, who therefore defiantly decided she was pretty all by herself. Then in 1937, when she was 14, Stalin's purges took them away. Her father was shot, her mother sent to a labour camp. Yelena, who had always romantically believed that the world needed Russia's revolution, refused to join the Communist Party until 1965, when her parents had been rehabilitated. Within seven years, appalled by the invasion of Czechoslovakia, she had left again.

Her work for others, slap in the face of Soviet bureaucracy and the KGB, piled up from that moment. She took on every plea for help that came to her, sending food or money, writing letters, finding rooms, whatever would make a difference. She was often ill, had several heart attacks, felt she was beating her head against the wall. But she would swallow her nitroglycerine pills, struggle up the stairs to argue with another official, stay ardently angry, in the hope of making her motherland acknowledge "the sovereignty of the individual".

The Soviet regime toppled eventually, but never fast enough for her. She fell out with Yeltsin over the war in Chechnya, and in 2010 was the first to sign a petition that Vladimir Putin should go. She also helped set up Memorial, an influential human-rights outfit focusing on the Caucasus. When Andrei had died in 1989 he had been given a state funeral, but she still bitterly believed that his life had been shortened by persecution. So, probably, had hers.

On one of her solitary girlhood walks, she once found herself accompanied by a lightning ball. It bounced along beside her, glowing like the moon, and struck a tree. It fell apart then, exploding in sparks, but she remembered how elated she felt to touch the scorch-mark and smell the hot, tarry smell of the destroyed wood. Her life, she thought, would burn like that.
